# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936

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## No. 186

## GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*vs.*

## ALBERT FRIED

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## No. 187

## GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*vs.*

## BENJAMIN EINHORN

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ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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INDEX


| | Original | Print |
|---|---|---|
| Proceedings before United States Board of Tax Appeals | 1 | 1 |
| Docket entries, no. 73,876 | 1 | 1 |
| Docket entries, no. 73,877 | 2 | 2 |
| Petition, no. 73,876 | 4 | 3 |
| Exhibit—Notice of deficiency | 9 | 5 |
| Answer, no. 73,876 | 14 | 7 |
| Petition, no. 73,877 | 15 | 8 |
| Exhibit—Notice of deficiency | 21 | 10 |
| Answer, no. 73,877 | 25 | 13 |
| Stipulation of facts | 27 | 13 |
| Findings of fact and opinion, Arundell, M | 34 | 17 |
| Dissenting opinion, Smith, M | 44 | 22 |
| Decision, no. 73,876 | 46 | 23 |
| Decision, no. 73,877 | 47 | 24 |
| Petition for review | 48 | 24 |
| Notice of filing petition for review | 54 | 27 |
| Affidavit of service | 55 | 27 |
| Praecipe for transcript of record | 56 | 27 |
| Clerk's certificate [omitted in printing] | 58 | 28 |
| Proceedings in U. S. C. C. A., Second Circuit | 59 | 28 |
| Opinion, Chase, J | 59 | 29 |
| Judgment, Fried vs. Commissioner | 61 | 31 |
| Judgment, Einhorn vs. Commissioner | 63 | 31 |
| Clerk's certificate [omitted in printing] | 64 | 31 |
| Orders allowing certiorari | 66 | 32 |

1 Before United States Board of Tax Appeals

Docket No. 73876

ALBERT FRIED, PETITIONER

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances:

For Petitioner: I. M. Pogash, C. P. A.

For Respondent: H. F. Morton, Esq., T. M. Mather, Esq., John T. Koehler, Esq.

*Docket entries*

1933

Sept. 29—Petition received and filed. Taxpayer notified. (Fee paid.)

Sept. 29—Copy of petition served on general counsel.

Oct. 27—Answer filed by general counsel.

Nov. 6—Copy of answer served on taxpayer.

1934

Jan. 20—Hearing set February 28, 1934.

Feb. 27—Order of continuance to March 12, 1934, for hearing on the merits entered.

Mar. 12—Hearing had before Mr. Arundell on merits—submitted. Dockets 73876 and 73877 consolidated for hearing and report. Stipulation of facts filed. Brief of petitioner due April 12, 1934—respondent's brief due April 27, 1934—petitioner's reply on May 7, 1934.

Mar. 16—Transcript of hearing of March 12, 1934, filed.

Apr. 12—Brief filed by taxpayer. April 12, 1934, copy served on general counsel.

2 May 2—Motion for extension to May 4, 1934, to file brief, brief lodged, filed by general counsel. May 4, 1934, granted.

May 16—Motion for extension to May 22, 1934, to file reply brief filed by taxpayer. May 17, 1934, denied.

Nov. 21—Findings of fact and opinion rendered—C. R. Arundell, Division 7. Decision will be entered for respondent.

Nov. 28—Decision entered—Mr. Arundell, Division 7.

1935

Feb. 27—Petition for review by United States Circuit Court of Appeals (Second) with assignments of error filed by taxpayer—affidavit of service thereon.

Feb. 27—Praecipe filed—affidavit of service thereon.

Before United States Board of Tax Appeals

Docket No. 73877

BENJAMIN EINHORN, PETITIONER

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances:

For Petitioner: I. M. Pogash, C. P. A.

For Respondent: H. F. Morton, Esq., T. M. Mather, Esq., John T. Koehler, Esq.

*Docket entries*

1933

Sept. 29—Petition received and filed. Taxpayer notified. (Fee paid.)

3 Sept. 29—Copy of petition served on General Counsel.

Oct. 27—Answer filed by General Counsel.

Nov. 6—Copy of answer served on taxpayer.

1934

Jan. 20—Hearing set February 28, 1934.

Feb. 27—Order of continuance to March 12, 1934, for hearing on the merits entered.

Mar. 12—Hearing had before Mr. Arundell on merits—submitted. Dockets 73,876 and 73,877 consolidated for hearing and report. Stipulation of facts filed. Petitioner's brief due April 12, 1934—respondent's brief due April 27, 1934—petitioner's reply May 7, 1934.

Mar. 16—Transcript of hearing of March 12, 1934 filed.

Apr. 12—Brief filed by taxpayer. April 12, 1934, copy served on General Counsel.

May 2—Motion for extension to May 4, 1934 to file brief, brief lodged, filed by General Counsel. May 4, 1934 granted.

May 16—Motion for extension to May 22, 1934, to file reply brief filed by taxpayer. May 17, 1934, denied.

Nov. 21—Findings of fact and opinion rendered—C. R. Arundell, Division 7. Decision will be entered for respondent.

Dec. 3—Decision entered—C. R. Arundell, Division 7.

1935

Feb. 27—Petition for review by United States Circuit Court of Appeals (Second) with assignments of error filed by taxpayer—affidavit of service thereon.

Feb. 27—Praecipe filed—affidavit of service thereon.

4 Before United States Board of Tax Appeals

[Title omitted.]

*Petition, No. 73876*

Filed Sept. 29, 1933

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT-AR-A-1-MGC-60D) dated August 1, 1933, and as a basis of his proceedings alleges as follows:

1. The petitioner is an individual and his address is 120 Broadway, New York City.

2. The notice of deficiency, a copy of which is attached herewith, was mailed to the petitioner on August 1, 1933.

3. The taxes in controversy are income taxes for the year 1931. The deficiency asserted is $14,238.88, of which $13,213.66 is in controversy.

4. The determination of the tax set forth in said notice of deficiency is based on the following errors:

5 a. The Commissioner erred in determining the income of the petitioner from the partnership of Albert Fried & Company.

b. The error resulted from the fact that the Commissioner classified the partnership of Albert Fried & Company, hereafter referred to as the partnership, as traders, instead of dealers in securities.

c. The Commissioner, as a result of his classification, valued the securities owned by the partnership at January 31, 1931, the end of its fiscal year, at $395,973.47, using cost as the basis, instead of valuing these securities at $335,306, using market price as the basis.

d. By using the cost basis, the Commissioner erroneously increased the partnership income by $60,667.47.

e. If the Commissioner's classification is correct, then he erred in valuing the securities owned by the partnership at the beginning of its fiscal year ended January 31, 1931, at market price and the securities on hand at the end of said year at cost.

5. The facts upon which the petitioner relies are as follows:

a. The petitioner was a partner in the firm of Albert Fried & Company, located at 120 Broadway, New York City.

b. The members of the partnership were the petitioner, whose share of the partnership profits was 95%, and Benjamin Einhorn, whose share was 5%.

6 c. The partnership was a member of the New York Stock Exchange, each of the partners having a membership in the Exchange.

d. The partnership was a specialist in thirteen stocks traded in on the New York Stock Exchange, and it was the sole specialist in these stocks.

e. The partnership's income was from commissions from brokers and profits on sale of securities, both earned chiefly on the thirteen stocks in which it specialized.

f. A specialist is a qualified member of the New York Stock Exchange who receives orders in selected securities from other members for execution. For executing these orders, the specialist receives a commission.

g. A specialist does not have a monopoly or exclusive grant from the Exchange. He is subject to competition from other members, who may, if they choose, compete with him in dealing in the stocks in which he specializes.

h. The partnership in order to keep its patronage maintained fair and ready markets in the stocks in which it specialized. The partnership always either had stocks on hand to fill buy orders or was in a position to buy stocks to fill sell orders.

i. The partnership was a merchant dealing in the stocks in which it specialized.

7 j. The partnership was regularly engaged in buying and selling these stocks.

k. The partnership's customers were all the members of the New York Stock Exchange or the principals, wherever located, for whom the Exchange members acted.

l. The partnership's established place of business for dealing in the stocks was its post on the floor of the New York Stock Exchange.

m. The securities owned by the partnership at January 31, 1931, the end of the its fiscal year, had a market value of $335,306 and cost value of $395,973.47.

n. The securities owned by the partnership at February 1, 1930, the beginning of its fiscal year, had a market value of $1,190,557.50, and a cost value of $1,204,171.

o. The partnership, in its books of account, regularly inventoried its securities on hand at market price and made its tax returns on the same basis. The returns were audited annually and accepted by the Commissioner.

6. Wherefore, the petitioner prays that this Board may hear the proceedings and determine:

a. That the partnership of Albert Fried & Company should be classified as dealers in securities.

b. That, as dealers, the securities owned by the partnership at the beginning and at the end of its fiscal year should be inventoried at market price.

8 c. That the deficiency due from the petitioner shall not exceed $1,025.22.

d. Or determining that the partnership was not a dealer in securities; that the securities owned by the partnership at the beginning of its fiscal year ended January 31, 1931, should be valued at cost price.

e. That determining the partnership was not a dealer in securities the deficiency due from the petitioner shall not exceed $11,005.67.

ISRAEL M. POGASH,
*Counsel for Petitioner,*
*17 Academy Street, Newark, N J.*

[*Duly sworn to by Albert Fried; jurat omitted in printing.*]

9 *Exhibit to petition*

NP-2-28

TREASURY DEPARTMENT,
*Washington, Aug. 1, 1933.*

Office of Commissioner of Internal Revenue.

Address reply to Commissioner of Internal Revenue and refer to IT:AR:A-1—MGC-60D.

Mr. ALBERT FRIED,
*120 Broadway, New York, New York.*

SIR: You are advised that the determination of your tax liability for the year 1931 discloses a deficiency of $14,238.88, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

However, if you do not desire to petition, you are requested to execute the inclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of
10 IT:C:P-7. The signing of this form will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed form, or on the date assessment is made, whichever is earlier; whereas if this form is not filed, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

GUY T. HELVERING,
*Commissioner.*

By (Signed) CHAS. T. RUSSELL,
*Deputy Commissioner.*

Inclosures:
Statement
Form 870
OS-2

Statement

IT:AR:A–1
MGC–60D

In re: Mr. Albert Fried, 120 Broadway, New York, New York

Income Tax Liability

| Year | Income tax liability | Income tax assessed | Deficiency |
|---|---|---|---|
| 1931 | $17,129.39 | $2,890.51 | $14,238.88 |

11 Reference is made to the report dated September 30, 1932, prepared by Revenue Agent Frank A. Harder, transmitted to you under date of November 19, 1932, and to your protest submitted under date of December 2, 1932.

Careful consideration has been accorded your protest in connection with the findings of the agent and the report on the conference held with you on March 29, 1933, in the office of the agent in charge, as well as to the data submitted at a conference held in this office with you on June 12, 1933, and the additional information received on July 10, 1933. The adjustments recommended by the agent have been approved in this office.

Your contention that the firm of Albert Fried and Company, a brokerage partnership of which you are a member, is entitled to inventory stock on the basis of being a dealer in securities has been denied for the reason that no evidence has been submitted which would indicate that the firm could qualify as a dealer in securities.

The evidence now before the Bureau indicates that the firm is in the business of stock brokers, classified as specialists in certain securities on the New York Stock Exchange.

Article 105 of Regulations 74 deals with the subject of inventories by dealers in securities and reads in part as follows:

"* * * For the purpose of this rule a dealer in securities is a merchant of securities * * * regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. * * *"

12 In view of the foregoing, it is held that the firm of Albert Fried and Company is not a merchant of securities with respect to the stock dealt in as a specialist, and, therefore, does not qualify as a dealer in securities with respect to the stock which it seeks to inventory.

| | |
|---|---|
| Net income shown in return | $51,003.92 |
| Add: | |
| 1. Partnership income | 66,146.09 |
| 2. Dividends | 3,515.00 |
| Total | 120,665.01 |
| Less: | |
| 3. Other deductions | 5,000.00 |
| Adjusted net income | 115,665.01 |

## Explanation of Changes

1 and 2. An examination of the books of account and records of Albert Fried and Company disclosed that your partnership income and dividends received from this source were $197,571.04 and $50,073.55 instead of $131,424.95 and $46,558.55 as reported by you.

3. The item of $5,000.00 representing a legal fee in connection with a suit by the Niagara Shares Corporation of Delaware against the Lincoln Interstate Holding Company previously deducted by Albert Fried and Company has been transferred to your return as being a personal expense.

13

## Computation of Tax

| | | |
|---|---|---|
| Income subject to surtax | | $115,665.01 |
| Less: | | |
| Dividends | $50,212.20 | |
| Personal exemption and credit for dependents | 4,700.00 | |
| | | 54,912.20 |
| Balance subject to normal tax | | $60,752.81 |
| Normal tax at 1½% on $4,000.00 | | $60.00 |
| Normal tax at 3% on $4,000.00 | | 120.00 |
| Normal tax at 5% on $52,752.81 | | 2,637.64 |
| Surtax on $115,665.01 | | 14,793.00 |
| Total | | $17,610.64 |
| Less: | | |
| Credit for earned net income of $30,000.00 | | 481.25 |
| Total income tax assessable | | $17,129.39 |
| Income tax previously assessed | | 2,890.51 |
| Deficiency in tax | | $14,238.88 |

Fiscal year income from partnership ended January 31, 1931. Rates for the years 1930 and 1931 are the same.

A copy of this letter has been transmitted to your attorney, Mr. Israel M. Pogash, 17 Academy Street, Newark, New Jersey, who has on file in this office a duly recorded power of attorney.

OS-2

14

## Before United States Board of Tax Appeals

[Title omitted.]

*Answer, No. 73876*

**Filed Oct. 27, 1933**

The Commissioner of Internal Revenue by his attorney, E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4–(a) to (e) incl. Denies that the Commissioner erred in the determination of the deficiency as alleged in sub-divisions (a) to (e) inclusive, of paragraph 4 of the petition.

5–(a) and (b). Admits the allegations contained in sub-divisions (a) and (b) of paragraph 5 of the petition.

5–(c) to (o) incl. Denies the allegations set forth in sub-divisions (c) to (o) inclusive, of paragraph 5 of the petition.

15 6. Denies generally and specifically each and every allegation contained in the petition of the above-named taxpayer not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the appeal be denied.

E. Barrett Prettyman,
(Signed) E. BARRETT PRETTYMAN,
*General Counsel,*
*Bureau of Internal Revenue.*

Of Counsel:
R. H. TRANSUE,
*Special Attorney,*
*Bureau of Internal Revenue.*
RHT/mjc-10-26-33

---

Before United States Board of Tax Appeals

[Title omitted.]

*Petition, No. 73877*

Filed Sept. 29, 1933

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal
16 Revenue in his notice of deficiency (IT–AR–A–1–MGC–60D) dated August 1, 1933, and as a basis of his proceedings alleges as follows:

1. The petitioner is an individual and his address is 120 Broadway, New York City.

2. The notice of deficiency, a copy of which is attached herewith, was mailed to the petitioner on August 1, 1933.

3. The taxes in controversy are income taxes for the year 1931. The deficiency asserted is $77.82 of which $56.24 is in controversy.

4. The determination of the tax set forth in said notice of deficiency is based on the following errors:

a. The Commissioner erred in determining the income of the petitioner from the partnership of Albert Fried & Company.

b. The error resulted from the fact that the Commissioner classified the partnership of Albert Fried & Company, hereafter referred to as the partnership, as traders, instead of dealers in securities.

c. The Commissioner, as a result of his classification, valued the securities owned by the partnership at January 31, 1931, the end of

its fiscal year, at $395,973.47, using cost as the basis, instead of valuing these securities at $335,306, using market price as the basis.

17 d. By using the cost basis, the Commissioner erroneously increased the partnership income by $60,667.47.

e. If the Commissioner's classification is correct, then he erred in valuing the securities owned by the partnership at the beginning of its fiscal year ended January 31, 1931, at market price and the securities on hand at the end of said year at cost.

5. The facts upon which the petitioner relies are as follows:

a. The petitioner was a partner in the firm of Albert Fried & Company, located at 120 Broadway, New York City.

b. The members of the partnership were the petitioner, whose share of the partnership profits was 5% and Albert Fried, whose share of the profits was 95%.

c. The partnership was a member of the New York Stock Exchange, each of the partners having a membership in the Exchange.

d. The partnership was a specialist in thirteen stocks traded in on the New York Stock Exchange, and it was the sole specialist in these stocks.

e. The partnership's income was from commissions from brokers and profits on sale of securities, both earned chiefly on the thirteen stocks in which it specialized.

18 f. A specialist is a qualified member of the New York Stock Exchange who receives orders in selected securities from other members for execution. For executing these orders, the specialist receives a commission.

g. A specialist does not have a monopoly or exclusive grant from the Exchange. He is subject to competition from other members, who may, if they choose, compete with him in dealing in the stocks in which he specializes.

h. The partnership in order to keep its patronage maintained fair and ready markets in the stocks in which it specialized. The partnership always either had stocks on hand to fill buy orders or was in a position to buy stocks to fill sell orders.

i. The partnership was a merchant dealing in the stocks in which it specialized.

j. The partnership was regularly engaged in buying and selling these stocks.

k. The partnership's customers were all the members of the New York Stock Exchange or the principals, wherever located, for whom the Exchange members acted.

l. The partnership's established place of business for dealing in the stocks was its post on the floor of the New York Stock Exchange.

19 m. The securities owned by the partnership at January 31, 1931, the end of its fiscal year, had a market value of $335,306 and cost value of $395,973.47.

n. The securities owned by the partnership at February 1, 1930, the beginning of its fiscal year, had a market value of $1,190,557.50, and a cost value of $1,204,171.

o. The partnership, in its books of account, regularly inventoried its securities on hand at market price and made its tax returns on the same basis. The returns were audited annually and accepted by the Commissioner.

6. Wherefore, the petitioner prays that this Board may hear the proceedings and determine:

a. That the partnership of Albert Fried & Company should be classified as dealers in securities.

b. That, as dealers, the securities owned by the partnership at the beginning and at the end of its fiscal year should be inventoried at market price.

c. That the deficiency due from the petitioner shall not exceed $21.68.

d. Or determining that the partnership was not a dealer in securities that the securities owned by the partnership at the be-
20 ginning of its fiscal year ended January 31, 1931, should be valued at cost price.

e. That determining the partnership was not a dealer in securities the deficiency due from the petitioner shall not exceed $50.61.

ISRAEL M. POGASH,
*Counsel for Petitioner,*
*17 Academy Street, Newark, N. J.*

[Duly sworn to by Benjamin Einhorn; jurat omitted in printing.]

21 *Exhibit to petition*

NP-2-28

TREASURY DEPARTMENT,
*Washington, Aug. 1, 1933.*

Office of Commissioner of Internal Revenue.

Address reply to Commissioner of Internal Revenue and refer to IT:AR:A-1—MGC-60D.

Mr. BENJAMIN EINHORN,
*% Albert Fried and Company,*
*120 Broadway, New York, New York.*

SIR: You are advised that the determination of your tax liability for the year 1931 discloses a deficiency of $77.82, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

However, if you do not desire to petition, you are requested to execute the inclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of
22 IT:C:P-7. The signing of this form will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed form, or on the date assessment is made, whichever is earlier; whereas if this form is not filed, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

GUY T. HELVERING,
*Commissioner.*

By (Signed) CHAS. T. RUSSELL,
*Deputy Commissioner.*

Inclosures:
Statement.
Form 870.
OS-2.

Statement

IT:AR:A-1
MGC-60D

In re Mr. Benjamin Einhorn, % Albert Fried and Company, 120 Broadway, New York, New York

Income Tax Liability

| Year | Income tax liability | Income tax assessed | Deficiency |
|---|---|---|---|
| 1931 | $94.59 | $16.77 | $77.82 |

Reference is made to the report dated September 30, 1932,
23. prepared by Revenue Agent Frank A. Harder, transmitted to you under date of November 19, 1932, and to your protest submitted under date of December 2, 1932.

Careful consideration has been accorded your protest in connection with the agent's findings and the report on the conference held with your partner, Mr. Albert Fried, on March 29, 1933, in the office of the agent in charge, as well as to the additional information which was considered at a conference held in this office on June 12, 1933, and the data received on July 10, 1933.

Your contention that the firm of Albert Fried and Company, a brokerage partnership of which you are a member, is entitled to inventory stock on the basis of being a dealer in securities has been denied for the reason that no evidence has been submitted which would indicate that the firm has qualified as a dealer.

Article 105 of Regulations 74 relating to the income tax under the Revenue Act of 1928 deals with the subject of inventories by dealers in securities and reads in part as follows:

"* * * For the purpose of this rule a dealer in securities is a merchant of securities * * * regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. * * *"

In view of the foregoing, it is held that the firm of Albert Fried and Company is not a merchant of securities with respect to
24 the stock dealt in as a specialist, and, therefore, does not qualify as a dealer in securities with respect to the stock which it seeks to inventory.

| | |
|---|---|
| Net income shown in return | $7,440.87 |
| Add: | |
| 1. Partnership income increased | 3,481.38 |
| Dividends increased | 185.00 |
| Adjusted net income | $11,107.25 |

## Explanation of Adjustments

1 and 2. An examination of the books of account and records of Albert Fried and Company disclosed that your partnership income and dividends from this source were $8,951.87 and $2,635.45, respectively, instead of $5,470.49 and $2,450.45, as reported.

## Computation of Tax

| | | |
|---|---|---|
| Net income subject to surtax | | $11,107.25 |
| Less: | | |
| Dividends | $2,635.45 | |
| Personal exemption and credit for dependent | 3,500.00 | |
| | | 6,135.45 |
| Balance subject to normal tax | | $4,971.80 |
| Normal tax at 1½% on $4,000.00 | | 60.00 |
| Normal tax at 3% on $971.80 | | 29.15 |
| Surtax on $11,107.25 | | 11.07 |
| Total | | $100.22 |
| 25 Less: | | |
| Credit for earned net income of $5,000.00 | | 5.63 |
| Income tax assessable | | 94.59 |
| Income tax previously assessed | | 16.77 |
| Deficiency | | 77.82 |

Fiscal year income from partnership ended January 31, 1931. Rates for the years 1930 and 1931 are the same.

A copy of this letter has been transmitted to your attorney, Mr. Israel M. Pogash, 17 Academy Street, Newark, New Jersey, who has on file in this office a duly recorded power of attorney.

OS-2

Before United States Board of Tax Appeals

[Title omitted.]

*Answer, No. 73877*

Filed Oct. 27, 1933

The Commissioner of Internal Revenue by his attorney, E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue, for
26 answer to the petition of the above-named taxpayer, admits and denies as follows:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4-(a) to (e) incl. Denies that the Commissioner erred in the determination of the deficiency as alleged in sub-divisions (a) to (e) inclusive, of paragraph 4 of the petition.

5-(a) and (b). Admits the allegations contained in sub-divisions (a) and (b) of paragraph 5 of the petition.

5-(c) to (o) incl. Denies the allegations set forth in sub-divisions (c) to (o), inclusive, of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation contained in the petition of the above-named taxpayer not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the appeal be denied.

E. Barrett Prettyman,
(Signed) E. BARRETT PRETTYMAN,
*General Counsel,*
*Bureau of Internal Revenue.*

Of Counsel:

R. H. TRANSUE,
*Special Attorney,*
*Bureau of Internal Revenue.*

RHT/mjc-10-26-33

27 Before United States Board of Tax Appeals

[Title omitted.]

*Stipulation of facts*

Filed March 12, 1934

It is hereby stipulated and agreed by and between the parties hereto, by and through their respective counsel, that the following facts may be taken and regarded as true, the same as if said facts had been proved by competent evidence introduced at the hearing of these appeals:

1. The single issue is whether petitioners as a partnership known as Albert Fried & Company were dealers in securities in which they specialize under Article 105, Regulations 74, Revenue Act of
28 1924, and therefore were entitled to inventory such securities at the end of the fiscal year at market value.

2. The co-partnership of Albert Fried & Company is composed of the following members: Albert Fried and Benjamin Einhorn, the petitioners above named. Albert Fried has a 95% interest and Benjamin Einhorn a 5% interest in the profits of the partnership.

3. The partnership was organized in March 1929 and has maintained offices, and at present is conducting its business at No. 120 Broadway, Borough of Manhattan, City of New York, State of New York.

4. The firm is a member of the New York Stock Exchange and each of the partners owns a membership on the Exchange and is subject to all the rules and regulations of the New York Stock Exchange.

5. The firm is a specialist in the following thirteen stocks traded in on the Exchange:

Northern Pacific Railway, common stock.
Air Reduction Co., common stock.
United Carbon Co., common stock.
American Zinc & Lead Smelting & Refining Co., common stock.
American Zinc & Lead Smelting & Refining Co., preferred stock.
Davega Stores Co., common stock.
A. Hollander & Sons, common stock.
Minnesota Moline Power Implement Co., common stock.
Minnesota Moline Power Implement Co., preferred stock.
Poor & Co. common stock.
29 Sterling Securities Co., A stock.
Sterling Securities Co., preference preferred.
Sterling Securities Co., convertible preferred.

6. A specialist on the New York Stock Exchange is a qualified member who accepts orders in selected securities from other members for execution.

7. The firm as a specialist filled such orders by either buying or selling its own securities or by matching like orders of a buyer and seller.

8. In addition to buying and selling for its own account the thirteen stocks in which it specialized and executing orders for these stocks for other members of the Stock Exchange for commissions, the firm's activities also included the purchase and sale of other stocks listed on the Exchange for its own account.

9. The firm leased space on the floor of the Exchange where it transacted its business in the thirteen stocks in which it specialized. The annual rental for this space is $2,000.00.

10. The firm held itself out generally and was known to all of the members of the Exchange as the specialist in these thirteen stocks,

and it was regularly and consistently engaged in the purchase and resale of such securities.

11. As business is transacted on the New York Stock Exchange, it is the practice for a member who desires to buy or sell a stock to place his order with the specialist in that stock.

12. The firm always had on hand the securities in which it specialized. Schedule 1 attached herewith shows the number of shares of these stocks owned by the firm at the end of each month in the year under review. As shown in this schedule, the shares carried ran from 10,300 shares at the end of one month to 62,300 at the end of another.

13. An analysis of a typical month's dealings in two of the stocks in which the firm specialized shows the following:

| Security | Total no. of shares sold on N. Y. S. E. in one month | Of the total sales, A. F. & Co. sold | % |
|---|---|---|---|
| Air Reduction comm. st | 126, 200 | 73, 700 | 59 |
| Northern Pacific R. R. comm | 328, 700 | 146, 700 | 45 |

Of the 126,200 shares of Air Reduction sold on the Exchange in one month, 59% was sold by the firm. Of a total of 328,700 shares of Northern Pacific sold on the Exchange in one month 45% represented shares sold by the firm.

14. Schedule 2 submitted herewith is a typical picture of the daily business done by the firm in the stocks in which it specializes.

15. All the stocks which the firm bought and sold were actually received and delivered by the firm.

16. The firm maintained an office at 120 Broadway, with a staff of eight people employed to receive and deliver securities and keep records in addition to the two partners.

17. For the year under review ending January 31st, 1931, the table below shows the volume of sales in shares and in dollars made by the firm:

| 31 | No. of Shares | Amount |
|---|---|---|
| Sales of 13 stocks specialized in | 1, 762, 100 | $125, 232, 632. 36 |
| Sales of other stocks | 119, 600 | 5, 127, 471. 40 |
| Total sales for year | 1, 881, 700 | $130, 360, 103. 76 |

18. The firm, ever since its inception, in its books of account regularly inventoried unsold securities on hand at market value, and in its tax returns computed its net income on the same basis.

19. On numerous occasions the partnership purchased and sold the securities in which it specializes in order to maintain fair and equitable markets and as far as possible tried to prevent wide fluctuation in such securities.

20. During the taxable year the partnership sold its thirteen securities to 431 customers, the sales ran from a minimum of 100 shares to a maximum of 5,700 shares. These customers were the other members of the Stock Exchange acting for themselves or for the principals for whom these members were acting as brokers.

(Sgd.) ISRAEL M. POGASH,
*Counsel for Petitioners.*

(Sgd.) ROBERT H. JACKSON,
*General Counsel,*
*Bureau of Internal Revenue.*

## Albert Fried & Company—Schedule 1

Number of Shares of the 13 Stocks Specialized in by the Firm, owned by the Firm at the end of each Month for the year Ended January 31, 1931:

| *Month—1930* | *No. of Shares Owned* |
|---|---|
| February | 47, 300 |
| March | 62, 300 |
| April | 39, 800 |
| May | 21, 600 |
| June | 18, 200 |
| July | 25, 300 |
| August | 32, 100 |
| September | 22, 900 |
| October | 23, 500 |
| November | 23, 300 |
| December | 10, 500 |
| *1931* | |
| January | 10, 300 |

## Schedule 2

## Albert Fried & Company

## Schedule Showing a Day's Trading in United Carbon and Air Reduction

Two of the stocks in which the firm specializes:

| | United Carbon | | Air Reduction | |
|---|---|---|---|---|
| | No. shares | Price | No. shares | Price |
| On hand at beginning of day | 100 | | 1,700 | |
| Purchases | 300 | 17⅝ | 100 | 69¼ |
| | 400 | 17⅝ | 100 | 69½ |
| | 400 | 17⅝ | 100 | 68½ |
| | 400 | 17⅝ | 100 | 68½ |
| | 100 | 17⅝ | 100 | 68¼ |
| | 900 | 18 | 100 | 68½ |
| | 200 | 17⅝ | | |
| | 100 | 18 | | |
| | 100 | 16⅞ | | |
| | 100 | 16⅞ | | |
| | 100 | 17 | | |
| Total purchases | 3,100 | | 600 | |

| | United Carbon | | Air Reduction | |
|---|---|---|---|---|
| | No. shares | Price | No. shares | Price |
| Sales | 200 | 18 | 200 | 69¾ |
| | 200 | 18 | 100 | 69⅞ |
| | 100 | 18 | 100 | 69⅞ |
| | 100 | 18 | 100 | 69½ |
| | 200 | 18⅛ | 100 | 69⅞ |
| | 100 | 17⅞ | 100 | 69⅞ |
| | 100 | 17⅞ | 1,000 | 69⅞ |
| | 200 | 17⅞ | 200 | 69⅞ |
| | 100 | 17⅞ | 100 | 69½ |
| | 100 | 17⅞ | 100 | 69⅞ |
| | 100 | 17⅞ | 100 | 69½ |
| | 500 | 17½ | 100 | 69¼ |
| | 100 | 17⅝ | 100 | 68 |
| | 100 | 17½ | 100 | 68¼ |
| | 100 | 17½ | | |
| | 100 | 17⅞ | | |
| | 200 | 17⅞ | | |
| | 100 | 17⅞ | | |
| | 100 | 17⅞ | | |
| | 100 | 18⅜ | | |
| | 100 | 18⅜ | | |
| | 100 | 17⅞ | | |
| | 100 | 17⅞ | | |
| Total sales | 3,200 | | 2,500 | |

34 Before United States Board of Tax Appeals

Docket No. 73876

ALBERT FRIED, PETITIONER

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

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Docket No. 73877

BENJAMIN EINHORN, PETITIONER

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*Findings of fact and opinion*

Promulgated November 21, 1934

The firm of which petitioners were members is a specialist in a group of stocks traded in on the New York Stock Exchange. *Held* that the firm's transactions in such stocks were not such as to make it a dealer within the meaning of article 105, Regulations 74, and it is not entitled to inventory them in determining income.

Israel M. Pogash, C. P. A., for the Petitioners.

H. F. Morton, Esq., Thomas N. Mather, Esq., and John T. Koehler, Esq., for the Respondent.

35 These proceedings involve deficiencies in income taxes of the members of a partnership for the year 1931, as follows: Docket No. 73,876, Albert Fried, $14,238.88; Docket No. 73,877, Benjamin Einhorn, $77.82.

A stipulation filed at the hearing reads in part that:

"The single issue is whether petitioners as a partnership known as Albert Fried & Company were dealers in securities in which they specialized under Article 105, Regulations 74, Revenue Act of 1928, and therefore were entitled to inventory such securities at the end of the fiscal year at market value."

*Findings of fact*

Petitioners are members of the firm of Albert Fried & Co., a partnership organized in March 1929, petitioner Fried having a 95 percent interest and petitioner Einhorn a 5 percent interest.

Each of the partners owns a membership on the New York Stock Exchange. The firm is a specialist in 13 stocks traded in on the exchange. The firm filled orders for its specialties either by buying or selling its own securities or by matching like orders of a buyer and seller. Space was leased by the firm on the floor of the exchange, where it transacted its business in the 31 stocks in which it specialized. The annual rental for this space is $2,000. The firm held itself out generally and was known to all of the members of the ex-
36 change as the specialist in its 13 stocks, and it was regularly and consistently engaged in the purchase and resale of those stocks. As business is transacted on the New York Stock Exchange, it is the practice for a member who desires to sell or buy a particular stock to place his order with the specialist in that stock.

The firm always had on hand some of the securities in which it specialized. The number of shares on hand as tabulated at the end of each month during the fiscal year ended January 31, 1931, ranged from a low of 10,300 to a high of 62,300 shares. In a typical months' dealings the firm's sales of one of its specialties represented 59 percent of the total sales on the exchange in that stock, and in the case of another of its specialties its sales were 45 percent of the total number sold on the exchange. In a typical day's trading the firm had on hand 100 shares of one of its specialties at the beginning of the day; it made 11 purchases aggregating 3,100 shares, and 23 sales aggregating 3,200 shares. In the case of another of its specialties it started the day with 1,700 shares, made 6 purchases amounting to 600 shares and 14 sales totaling 2,500 shares. During the taxable year the firm sold its 13 specialties to 431 customers; the sales ran from a minimum of 100 shares to a maximum of 5,700 shares. The customers mentioned were other members of the exchange acting for themselves or as brokers.

In addition to buying and selling for its own account the 13 stocks in which it specialized, and executing orders for such stocks for other members of the exchange for commission, the firm's activities

37 included the purchase and sale for its own account of other stocks listed on the exchange. The firm's sale of its specialty stocks in the year ended January 31, 1931, amounted to $125,232,-632.36, represented by 1,762,100 shares; its sales of other stocks were in the amount of $5,127,471.40, the shares numbering 119,600. On numerous occasions the firm purchased and sold the shares in which it specialized in order to stabilize markets and as far as possible tried to prevent wide fluctuation in those stocks.

All the stocks which the firm bought and sold were actually received and delivered by it. The firm maintained an office at 120 Broadway, with a staff of eight people employed to receive and deliver securities and keep records. These eight employees were in addition to the two partners. Ever since its inception the firm has regularly inventoried in its books of account its unsold securities on hand at market value, and in its income tax returns it has computed its net income on the same basis.

*Opinion*

ARUNDELL: Petitioners concede that the firm of which they are members is not a dealer as to the stocks other than those in which it specializes. They claim that the firm is a "dealer in securities" as to the 13 specialty stocks within the meaning of article 105, Regulations 74, and consequently may inventory those stocks in computing income.

In a consideration of cases involving the question presented here it should be remembered that the taxing statute deals primarily
38 with realized gains or losses. Lucas v. American Code Co., 280 U. S. 445. In order for a taxpayer to use some other method of computing gain or loss he must show clearly that he comes within statutory provisions which allow a departure from the fundamental aim of the statute. If a departure is permissible here it is under section 22 (c) of the Revenue Act of 1928, reading as follows:

"Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The application of this section is, by its language, confined to rather narrow limits. It does not extend to all cases in which taxpayers think that income can be reflected on an inventory basis. Only in the class of cases where in the opinion of the Commissioner the use of inventories is necessary can the inventory method be used. We have heretofore had occasion to say that the inventory method of computing income "has always been regarded as special and as involving problems of general administration peculiarly cognizable by the Commissioner." Alfred E. Hamill, 30 B. T. A. 955. In that case, after quoting the statute as set out above, we further said:

39 "Fortified with such a clear sanction in the statutory grant of power, the administrative determination in such a case must survive all but the strongest attack. Short of being arbitrary or capricious or based on a clear demonstration of error, the determination in any single instance ought not to be disturbed. This is not a matter of jurisdiction, for the Board clearly has the power of review, Blair v. Oesterlein Machine Co., 275 U. S. 220, but is rather an attitude of the Board in the exercise of its jurisdiction not to interfere lightly with general administrative matters which the Congress has entrusted to the Comissioner's discretion." * * *

The question ultimately presented for decision here is whether the petitioners have made a strong enough case to show that the respondent erred in refusing to classify the firm as a dealer. The burden of so doing, we said in the Hamill case, is "undoubtedly heavier than that of overthrowing a purely factual determination upon which the ultimate determination must stand."

Petitioners say that their firm is a dealer within the following definition contained in article 105:

* * * "For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that
40 is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."

In the case of James B. Lowell, 30 B. T. A. 1296, we had before us a specialist in three stocks traded in on the New York Stock Exchange. In our opinion in that case we said in part:

"Some of the transactions in these stocks consisted of matching purchase orders against sales orders, the orders on both sides of the book being received from brokers, and for this service a commission was paid by the brokers. It is obvious that in such transactions no securities would need be carried in stock if the buy and sell orders matched up evenly each day. To what extent they were even is not shown, but the testimony of petitioner James B. Lowell is that he endeavored to come out as nearly even as possible. Transactions of this kind, in our opinion, cannot be classified as the "purchase of securities and their resale to customers." Art. 105, Regulations 74. The petitioner in such case was not selling securities previously purchased, but was rather acting as a broker on a commission basis. A dealer or merchant gains or loses directly in proportion to fluctuations in the market price of the commodity in which he deals; not so with petitioners in their matching operations, for no matter how much the spread in prices their commission was the same on each 100-share lot cleared on their books.

41 "The other transactions in the specialty stocks were not such as to come within the generally accepted understanding of the terms of merchant or dealer. They were purchases or sales, sometimes short sales, made when there were no matching orders on the

books. These transactions, according to the testimony, were for the purpose of creating or maintaining a market; they were speculative, as explained by the witness, in that he was betting on a rise or fall in the market according to whether he was long or short of the stock. An effort was made to even up on each transaction within the day though this was not always accomplished. These transactions were engaged in to maintain the market only for the day; they were engaged in on margin with Wrenn Brothers; no certificates were issued in the names of petitioners or the partnership; and neither the petitioners nor their partnership could deal directly with the public. These matters demonstrate the width of the gap between the petitioners and a dealer or merchant, who is generally understood to be one who carries a stock of his wares and stands ready to deal directly with all who wish to trade in that commodity." * * *

The essential in the Lowell case and these are the same, and what we said in the former case controls our decision here. The facts in the instant case were stipulated and the stipulation omits some of the detailed evidence presented in the Lowell case as to the oper-
42 ating methods of specialists on the stock exchange. But this lack of evidence may not be availed of by petitioners, for on them rests the burden of overcoming the prima facie correctness of the respondent's determination. Their claim is that the activities of the firm as a specialist bring it within the definition of a dealer, without describing the operating methods of the specialist or even explaining the specialist's function. When we refer to the reported cases, the descriptions given of the activities and operating methods of specialists fall far short of bringing them within the meaning of "dealers" as defined by article 105. See James B. Lowell, supra; People v. Goldfogle, 213 App. Div. 702; 211 N. Y. 107.[1]

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[1] [People *v.* Goldfogle, supra.] * * * The "specialist" is a floor broker, who undertakes to specialize in a limited group of stocks, and a firm conducting a "specialist" business is one which is represented by one or more such floor brokers. For the convenience of brokers and to expedite the execution of orders, all the stocks listed on the Stock Exchange are around different "posts" located on the floor. * * *

The specialist stations himself at one of the posts on the floor, where he remains from 10 a. m. to 3 p. m., accepting orders coming from other Stock Exchange members in the stocks listed at his post. He is always at his post, and the orders he receives are usually those impossible of execution at the time they are given out, but which come into force as the market advances or declines. The necessity for specialists arises from the rigid responsibility to which Stock Exchange members are held for the execution of orders when market conditions permit. At times, great loss would result to brokers doing business around the room, unless they could pass this responsibility on to the specialist.

When a specialist accepts an order from another member, he assumes responsibilities and liabilities which are recognized and ruled upon by the governors of the Exchange under the rules of the Exchange. In some cases, the specialist, when he buys and sells for a Stock Exchange house, "gives up" on a transaction—i. e., discloses the name of his principal. These transactions are cleared and settled by the Stock Exchange firms for whom the purchases or sales are made, and the specialist neither makes payment for the securities bought nor receives payment for the securities sold. He remains liable as a principal, however, to the party to whom he sold or from whom he bought until the due date of the settlement of the contract, although he takes no further part in the handling of the details pending the closing of the contract. He is responsible for the carrying out of the contract. In many cases, the specialist does not disclose the name of his principal, but gives either his own name or the name of the firm with which he is associated, in which case his liability remains as above. In a few cases a specialist may avoid liability where he specifically states at the time of the purchase or sale that he is buying or selling for the account of some other broker. The other broker then becomes liable, and the specialist steps out. Such a case is exceptional; as a general rule the specialist remains liable.

* * * * * * *

The specialist who executes orders received from other members of the Stock Exchange receives a certain proportion of the commission paid to the other Stock Exchange members by their customers; for instance, where stock has a par value of $100, the broker's commission is $15 per 100 shares. Of this $15, the specialist receives $2.50.

43 Referring to some of the confused facts stipulated, it is set forth in the stipulation that the firm always had on hand some of the securities in which it specialized. This, standing alone, is incomplete and possibly misleading, for it is a matter of general knowledge and is indicated by the cases above that it is neither the function nor aim of a specialist to carry on hand at all times a sufficiently large stock of his specialty stocks to meet all demands. His ability to supply the demand depends largely on his ability to match orders rather than upon the quantity of stock on hand. Again, there is a reference in the stipulation to the firm's buying and selling "for its own account." The statement is not explained. If such transactions were for investment or speculation they are outside the activities of a dealer. See Adirondack Securities Corporation, 23 B. T. A. 61; Northeastern Surety Co., 29 B. T. A. 297. Moreover, under the rules of the stock exchange, a member while acting as broker,
44 whether specialist or otherwise, is prohibited, with certain specified exceptions, from buying or selling for his own account securities for which he has accepted orders to buy or sell. See Charles H. Meyer, The Law of Stock Brokers and Stock Exchanges, § 51.

It is unnecessary to consider whether other brokers with or through whom the firm dealt were "customers." That was the principal point involved in the Estate of Harry E. R. Hall, 29 B. T. A. 1255, upon which petitioners rely. Even if it be conceded that a broker may be a customer, it does not follow that every one with whom a broker deals is a dealer or merchant. One who is admittedly a broker, or a speculator, may have customers—indeed he must have in the sense of having some one to sell to—but that does not make him a merchant.

We are accordingly of the opinion, and so hold, that petitioners have not sustained the burden of establishing that the respondent erred in refusing to classify their firm as a dealer within the meaning of the regulations.

Reviewed by the Board.

Decision will be entered for the respondent.

MURDOCK concurs in the result.

*Dissenting opinion*

SMITH, dissenting: In Estate of Harry E. R. Hall, 29 B. T. A. 1255, we held that specialists on the New York Stock Exchange who were engaged in the business of buying securities and reselling them to customers, principally members of the New York Stock Exchange, were entitled under article 105 of Regulations 74 to compute
45 net income upon the basis of inventories at market. I think there are no material differences between the facts in this case and those which obtained in the above cited case. Furthermore, I am of the opinion that the petitioners here substantially met the

requirements of article 105 to qualify them as dealers in securities. They have an established place of business; they are regularly engaged in the purchase of securities and their resale to customers, and those purchases and sales are made with a view to the gains and profits that may be derived therefrom. If the regulation was intended to apply only to underwriters or distributors of securities that fact is not made plain by the terms of the regulation, nor can I understand why such merchants of securities should be favored by the respondent over brokers who make a practice of buying for their own account and selling to customers the securities thus bought with a view to gains and profits to be derived therefrom.

Substantially the question presented here was considered by the Circuit Court of Appeals for the Second Circuit in Harriman National Bank v. Commissioner, 43 Fed. (2d) 950. It was there held that a bank, maintaining a separate department for the buying and selling of securities, which sold securities when it thought the prices were reasonable, was a dealer in securities within the contemplation of article 1585 of Regulations 45, which corresponds with article 105 of Regulations 74.

As I see it, the only question which we have here is whether
46 the petitioners qualify as dealers in securities as defined in the regulation. I think they do.

BLACK, MCMAHON, and LEECH agree with this dissent.

Before United States Board of Tax Appeals, Washington

Docket No. 73876

ALBERT FRIED, PETITIONER

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*Decision*

Pursuant to the determination of the Board, as set forth in its report promulgated November 21, 1934, it is

Ordered and decided: There is a deficiency in income tax for the year 1931 in the amount of $14,238.88.

Enter.

Entered December 3, 1934.

[SEAL] (Signed) C. R. ARUNDELL,
*Member.*

Copies served on both parties.

47 Before United States Board of Tax Appeals, Washington

Docket No. 73877

BENJAMIN EINHORN, PETITIONER,

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

*Decision*

Pursuant to the determination of the Board, as set forth in its report promulgated November 21, 1934, it is

Ordered and decided: That there is a deficiency in income tax for the year 1931 in the amount of $77.82.

Enter.

Entered November 28, 1934.

[SEAL]

(Signed) C. R. ARUNDELL,
*Member.*

Copies served on both parties.

48 In United States Circuit Court of Appeals for the Second Circuit

[Title omitted.]

*Petition for review*

Filed Feb. 27, 1935

*To the Honorable Judges of the United States Circuit Court of Appeals for the Second Circuit:*

Now come Albert Fried and Benjamin Einhorn, the Taxpayers, by their attorney, Leo K. Martus, and respectfully show:

I

The petitioners on review (hereinafter referred to as the Taxpayers) are partners of the firm of Albert Fried & Company,
49 having their place of business at 120 Broadway, New York City, State of New York. The respondent on review (hereinafter referred to as the Commissioner) is the duly appointed, qualified and acting Commissioner of Internal Revenue of the United States holding his office by virtue of the laws of the United States.

The income tax report for the taxable year 1931, being the taxable year involved herein, upon which a deficiency was determined, was filed with the United States Collector of Internal Revenue for the Second District of New York, and the office of said Collector is

located within the judicial Circuit of the United States Circuit Court of Appeals for the Second Circuit.

II

The Commissioner determined a deficiency in Federal income taxes against each of the Taxpayers for the year 1931 as follows:

| | |
|---|---|
| Docket No. 73,876, Albert Fried | $14,238.88 |
| Docket No. 73,877, Benjamin Einhorn | 77.82 |

and in accordance with the provisions of Section 272 (Rev. Act 1928) sent to the Taxpayers notices of said deficiencies. Thereafter the Taxpayers duly filed an appeal from the said notices of deficiencies with the United States Board of Tax Appeals. The cases were consolidated for hearing and decision, and were submitted on a Stipulation of Facts. Petitioners and Respondent filed briefs on said appeal to the Board of Tax Appeals and the Board of Tax Appeals promulgated its opinion, and on November 28,
50 1934, duly entered its decision in docket No. 73,876 wherein and whereby the Board ordered and decided, by divided vote, four of the members of the Board dissenting, that there was a deficiency for the year 1931 of $14,238.88 against petitioner Albert Fried, and on December 3, 1934, duly entered its decision in docket No. 73,877 against petitioner Benjamin Einhorn in the sum of $77.82.

III

The deficiencies which were in controversy before the Board of Tax Appeals arose or resulted from the determination of the Commissioner that the Taxpayers as partners of the firm of Albert Fried & Company were not dealers in securities under Article 105, Regulation 74, Revenue Act of 1928.

IV

The Taxpayers say that in the record and proceedings before the Board of Tax Appeals in the opinion and decision rendered and entered by the Board manifest error occurred and intervened to the prejudice of the Taxpayers and the Taxpayers file the following errors, and each of them in which they aver occurred in the said record, proceedings, decision, and upon which they rely to reverse the said opinion and decision so rendered and entered by the Board of Tax Appeals.

The petitioners assign as errors the following acts and omissions of the Board of Tax Appeals. The Board erred in holding:
51 1. That petitioners were not dealers in securities under Article 105, Regulation 74, Revenue Act of 1928, and were therefore not entitled to inventory such securities at the end of the fiscal year at market value.

2. That the inventory method may be used by Taxpayers "only in the class of cases where in the opinion of the Commissioner the use of inventories is necessary" and in disregarding and failing to hold that Article 105, Regulation 74, Revenue Act of 1928, is controlling on the Commissioner.

3. That the essentials in the case of James B. Lowell, 30 B. T. A. 1926, and in the instant case are the same, and in failing to distinguish between the facts in the aforesaid case with the facts in the instant case.

4. That the petitioners failed to give detailed evidence as to the operating methods of a specialist in the New York Stock Exchange, which evidence is clearly submitted in items 5 to 11 inclusive of the Stipulation of Facts and in seeking such definition outside of the record.

5. That the Stipulation of Facts setting forth that the firm always had on hand some of the securities in which it specialized was incomplete and misleading. This evidence was clearly submitted in items 12 to 34 inclusive of the Stipulation of Facts, and in Schedule 1 annexed to the Stipulation.

6. That the statement in the Stipulation of Facts "for its own account" is not explained, and in not accepting the ordinary
52 meaning thereof, i. e., buying in their own name, obtaining legal possession and selling in their own name, and acting for themselves as principal and not as broker or agent for others.

7. That under the rules of the New York Stock Exchange a member while acting as broker is prohibited from buying or selling for his own account securities for which he has orders to buy or sell.

8. That the facts in the instant case were materially different from the facts in the Matter of the Estate of Harry E. R. Hall, 29 B. T. A. 1255 (where the Board held that a Specialist on the New York Stock Exchange engaged in the business of buying securities and reselling them to customers was entitled under Article 105, Regulation 74, Revenue Act of 1928, to compute net income upon the basis of inventories at market).

9. In deciding and determining that there are deficiencies of income tax for the year 1931 against petitioner Albert Fried in the sum of $14,238.88 and against Benjamin Einhorn in the sum of $77.82.

Wherefore the Taxpayers petition that the decision of the United States Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Second Circuit, that a transcript of the record be prepared in accordance with law and the rules of said Court and transmitted to the Clerk of said Court for filing, and
53 that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

LEO K. MARTUS,
*Attorney for Petitioners,*
*Office & P. O. Address, 521 Fifth Avenue,*
*Borough of Manhattan, City of New York.*

[Duly sworn to by Albert Fried; jurat omitted in printing.]

54 In United States Circuit Court of Appeals for the Second Circuit

[Title omitted.]

*Notice for Filing of Petition for Review*

To the COMMISSIONER OF INTERNAL REVENUE,
*Washington, D. C.:*

To ROBERT H. JACKSON,
*General Counsel, Bureau of Internal Revenue,*
*Washington, D. C.:*

You are hereby notified that Albert Fried and Benjamin Einhorn, the petitioners in the above entitled action, did on the 26th day of February, 1935, file with the Clerk of the United States Board of Tax Appeals at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Second Circuit of the decisions of the Board heretofore rendered in the above entitled consolidated actions.

55 A copy of the petition for review and the assignment of errors as filed is hereto attached and served upon you.

Dated, this 26th day of February, 1935.
Yours, etc.,

LEO K. MARTUS,
*Attorney for Petitioners,*
*521 Fifth Avenue, New York City.*

*Affidavit of service*

State and County of New York, *ss.:*

Tillye B. Aaronson, being duly sworn, deposes and says, that on the 26th day of February, 1935, she served the within Petition for Review and notice of date of filing thereof on Robert H. Jackson, General Counsel to the Respondent in this action, through the post office by depositing a true copy thereof, properly enclosed in a post-paid wrapper in a post office box regularly maintained by the Government of the United States at 521 Fifth Avenue, Borough of Manhattan, City of New York, directed to said Robert H. Jackson, General Counsel, at Bureau of Internal Revenue, Washington, D. C., that being the address designated by him for that purpose.

(Signed) TILLYE B. AARONSON.

Sworn to before me this 26th day of February, 1935.

MORRIS MITCHELL,
Signed MORRIS MITCHELL
*Notary Public.*

56 In United States Circuit Court of Appeals for the Second Circuit

[Title omitted.]

Praecipe for transcript of record

Filed Feb. 27, 1935

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Second Circuit, copies duly certified as correct of the following documents and records of the above entitled causes in connection with the petition for review by the said United States Circuit Court of Appeals for the Second Circuit heretofore filed by petitioners, Albert Fried and Benjamin Einhorn:

57 1. Docket entries of the proceedings before the Board.

2. Petition with schedules, and annexed copies of deficiency notice.

3. Other pleadings before the Board, if any.

4. Agreed Stipulation of Facts.

5. Opinion and Decision of the Board.

6. Petition for review together with proof of service of notice of filing petition for review and of service of a copy of petition for review.

7. This praecipe.

Leo K. Martus,
*Attorney for Petitioners,*
*521 Fifth Avenue, New York City.*

58 [Clerk's Certificate to foregoing transcript omitted in printing.]

59 In United States Circuit Court of Appeals for the Second Circuit

No. 9—October Term, 1935

Argued Feb. 13, 1935. Decided April 6, 1936

Albert Fried, petitioner

*vs.*

Commissioner of Internal Revenue, respondent

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Benjamin Einhorn, petitioner

*vs.*

Commissioner of Internal Revenue, respondent

Appeal From the Board of Tax Appeal Before Manton, Swan, and Chase, Circuit Judges

Petitions, consolidated for hearing, to review decisions of the Board of Tax Appeals redetermining deficiencies in income taxes for 1931. Reversed.

Leo K. Martus, of New York City (John J. Curtin, of New York City, of counsel), for Albert Fried and Benjamin Einhorn, copartners doing business under the firm name of Albert Fried & Co.

Frank J. Wideman, Asst. Atty. Gen., and Seawall Key and L. W. Post, Sp. Assts. to Atty Gen.

*Opinion*

CHASE, Circuit Judge.

Each petitioner is one of the two partners constituting the partnership of Albert Fried & Co., brokers. Each partner owned a membership in the New York Stock Exchange where the firm leased floor space for the transaction of its business during the taxable year. An office was also maintained by the firm at 120 Broadway in New York City.

It was stipulated, inter alia, that during the taxable year 1931, the partnership specialized in thirteen different securities which were traded in regularly on the Stock Exchange. It was customary for it to keep on hand supplies of the shares in which it specialized and to buy and sell such shares as it received orders from other members of the Exchange; its business as the specialist in such stocks being to execute orders at the prevailing market price either for purchase or sale as customers might require. All the stock it bought was actually received by it, and all it sold was delivered. At times it could and did match buying and selling orders. It at all times carried at the end of a month during the year from 10,300 shares to 62,300 shares for resale, and regularly inventoried all unsold securities on hand at market value. The income return of the firm was made upon the basis on which its books were kept, and its practice to inventory securities kept for sale was consistent. During 1931 it sold securities to 431 customers whose purchases ranged from a minimum of 100 shares at a time to 5,700 shares. It bought and sold the greater part of all the shares of stock in which it
60 specialized which were traded on the Exchange in 1931, and often bought or sold to keep the price from fluctuating too widely. Its purchases and sales were frequent, substantial, and regular.

The firm also bought and sold securities in which it was not the specialist, but as to them no claim is made that it was a dealer.

The deficiencies redetermined arose as a result of the refusal of the Commissioner to allow the tax to be computed on the basis of inventories, and were sustained because a majority of the Board decided that petitioners had failed to show that they were dealers in the thirteen different stocks in which the firm specialized and so entitled to the use of inventories in computing taxable income. The decisive question is whether they were dealers entitled to do so under section 22 (c) of the Revenue Act of 1928 (26 U. S. C. A. § 22 and note) and article 105 of T. R. 74.

The above statute required a taxpayer to use inventories whenever in the opinion of the Commissioner their use was necessary in order clearly to reflect taxable income, and when required they were to be taken upon an approved basis "conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Article 105 of T. R. 74 follows:

"Art. 105. Inventories by dealers in securities.—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either—

"(a) At cost;

"(b) At cost or market, whichever is lower; or

"(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to on subsequent years unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule."

This regulation recognizes that a taxpayer may be a dealer in some securities and not in others bought or sold. The dealer is one who, having an established place of business, may be said to keep securities as though on his shelves to supply the wants of regular customers as does an established merchant his goods. He is to be distinguished from the speculator in stocks and from the investor. See Harriman National Bank v. Commissioner (C. C. A.) 43 F. (2d) 950, and Seeley 1. Helvering (C. C. A.) 77 F. (2d) 323.

Though the Board of Tax Appeals was divided in opinion on whether the stipulated facts were enough proof of the status as dealers of the petitioners in respect to the stocks in which Fried & Co. specialized and the majority thought not, we believe these facts bring this case within our decision in Commissioner v. Stevens, 78 F. (2d) 713. We can find no material difference whatever between that case and this. Following our decision in the Stevens

Case, we feel bound to hold that the petitioners have shown themselves to be within the scope of the above-quoted regulation and entitled to the use they made of inventories.

Decisions reversed and remanded for further proceedings in accord with the foregoing.

61 In United States Circuit Court of Appeals, Second Circuit

ALBERT FRIED, PETITIONER

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*Judgment filed April 13, 1936*

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said United States Board of Tax Appeals be and it hereby is reversed and cause remanded for further proceedings in accordance with the opinion of this Court.

It is further ordered that a Mandate issue to the said Board in accordance with this decree.

62 [File endorsement omitted.]

63 In United States Circuit Court of Appeals, Second Circuit

BENJAMIN EINHORN, PETITIONER,

*vs.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*Judgment filed April 13, 1936*

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said United States Board of Tax Appeals be and it hereby is reversed and cause remanded for further proceedings in accordance with the opinion of this Court.

It is further ordered that a Mandate issue to the said Board in accordance with this decree.

64 [File endorsement omitted.]

[Clerk's certificate to foregoing transcript omitted in printing.]

66 Supreme Court of the United States

No. 186, October Term, 1936

*Order allowing certiorari*

Filed October 12, 1936

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted, and the case is advanced and assigned for argument on Tuesday, November 10, next, following Nos. 24, 25, and 26.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

67 Supreme Court of the United States

No. 187, October Term, 1936

*Order allowing certiorari*

Filed October 12, 1936

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted, and the case is advanced and assigned for argument on Tuesday, November 10, next, following Nos. 24, 25, and 26.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Endorsement on cover:] File Nos. 40, 726, 40, 727. U. S. Circuit Court of Appeals, Second Circuit. Term No. 186. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. Albert Fried. Term No. 187. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. Benjamin Einhorn. Petition for writs of certiorari and exhibit thereto. Filed July 13, 1936. Term Nos. 186 O. T. 1936, 187 O. T. 1936.

U. S. GOVERNMENT PRINTING OFFICE: 1936

# INDEX


| | Page |
|---|---|
| Opinions below | 2 |
| Jurisdiction | 2 |
| Question presented | 2 |
| Statute and regulations involved | 2 |
| Statement | 4 |
| Specification of errors to be urged | 6 |
| Reasons for granting the writ | 6 |


## CITATIONS


| | |
|---|---|
| Cases: | |
| *Commissioner* v. *Stevens*, 78 F. (2d) 713 | 6, 7 |
| *Schafer* v. *Helvering*, 83 F. (2d) 317, certiorari granted May 18, 1936 | 6, 7 |
| Statute: | |
| Revenue Act of 1928, c. 852, 45 Stat. 791: | |
| Sec. 22 | 2 |
| Miscellaneous: | |
| Treasury Regulations 74: | |
| Art. 105 | 3 |




79432—36

# In the Supreme Court of the United States

OCTOBER TERM, 1936

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NOS.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

ALBERT FRIED

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BENJAMIN EINHORN

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**PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT**

The Solicitor General on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Second Circuit, entered in the above causes on April 13, 1936, reversing the decisions of the Board of Tax Appeals.

### OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 34–46) is reported in 31 B. T. A. 130. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 59) is not yet reported.

### JURISDICTION

The judgments of the Circuit Court of Appeals were entered April 13, 1936. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether the respondents were dealers in certain securities in which they specialized so as to entitle them to inventory the securities at market value in determining income.

### STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

> SEC. 22. GROSS INCOME.
>
> * * * * *
>
> (c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.
>
> * * * * *

Treasury Regulations 74:

ART. 105. *Inventories by dealers in securities.*—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either—

(a) At cost;

(b) At cost or market, whichever is lower; or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships

who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

## STATEMENT

The cases were consolidated and involve the same question and the same facts. The facts were stipulated, and, as found by the Board of Tax Appeals, are, so far as material, as follows:

The respondents are members of the partnership firm of Albert Fried & Co. Each of the partners owned a membership on the New York Stock Exchange, where floor space was leased for the transaction of the firm's business. The firm also maintained an office in New York City. (R. 35, 37.)

The firm was a specialist in thirteen stocks traded in on the exchange. (R. 35.) It always had on hand some of the securities in which it specialized, and as of the end of each month of the fiscal year ended January 31, 1931, the year involved here, its supply ranged from 10,300 shares to 62,300 shares. (R. 36.) It filled orders for its specialties either by buying or selling its own securities or by matching like orders of a buyer and seller. (R. 35.) The firm held itself out generally and was known to all of the members of the exchange as the specialist in its thirteen stocks, and it was regularly and consistently engaged in the purchase and resale of those stocks. (R. 35–36.) Its

customers were other members of the exchange acting for themselves or as brokers, and during the taxable year the firm sold its specialties to 431 of these members. (R. 36.) All the stocks which the firm bought and sold were actually received and delivered by it. (R. 37.)

The firm's activities also included the purchase and sale for its own account of other stocks listed on the exchange. (R. 36–37.) On numerous occasions the firm purchased and sold the shares in which it specialized in order to stabilize markets and as far as possible tried to prevent wide fluctuation in those stocks. (R. 37.)

Ever since its inception the firm has regularly inventoried in its books of account its unsold securities on hand at market value, and in its income tax returns it has computed its net income on the same basis. (R. 37.)

In determining the tax liabilities of the respondents for the year here in question, the Commissioner denied their contention that the firm was entitled to inventory stock on the basis of being a dealer in securities, and accordingly asserted deficiencies against the respondents. (R. 9, 11; 21, 23.) The Board of Tax Appeals approved the Commissioner's action (R. 44), but the Circuit Court of Appeals for the Second Circuit reversed the Board, remanding the cases for further proceedings in accordance with its opinion. (R. 59.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the partners are dealers in securities so as to entitle them to the use of inventories in computing income.

2. In construing Section 22 (c) of the Revenue Act of 1928, *supra,* as embracing the business of the partners.

3. In holding that the partners had shown themselves to be within the scope of Article 105 of Regulations 74, *supra.*

4. In reversing the decision of the Board of Tax Appeals and remanding for further proceedings in accordance with its opinion.

REASONS FOR GRANTING THE WRIT

On May 18, 1936, this Court granted writs of certiorari (Nos. 24, 25, 26, October Term, 1936) to review the decision of the Court of Appeals for the District of Columbia in the cases of *Schafer* v. *Helvering,* 83 F. (2d) 317.

In the petition for writs of certiorari in those cases, the taxpayers asserted that those cases are in conflict with the decision of the Second Circuit in *Commissioner* v. *Stevens,* 78 F. (2d) 713, which the present case expressly follows.

The Court of Appeals for the District in its opinion in the *Schafer* cases stated (p. 318):

> Petitioners rely upon *Commissioner* v. *Stevens* (C. C. A. Second Circuit) 78 F. (2d) 713, and *Commissioner* v. *Charavay*

(C. C. A. Third Circuit) 79 F. (2d) 406, and insist that the facts in those cases and in this are indistinguishable; and in our opinion this is correct. If we follow them, we should be content to accept their conclusions as our own; but after careful thought, and with great deference, we are constrained to adopt a different view.

The Government filed a brief opposing certiorari in the *Schafer* cases, taking the position that the decision of the Court of Appeals in those cases was correct, and seeking to distinguish the *Schafer* cases from the *Stevens* and *Charavay* cases because of certain differences in the facts of those cases. The granting of the *Schafer* petition casts doubt on the soundness of the distinction which the Government sought to make. We believe, however, that the decision in the *Schafer* cases is correct and that the decision in the present cases reversing the Board of Tax Appeals is incorrect.

In view of the pendency of the *Schafer* cases, and in view of the asserted conflict between those cases and the *Stevens* case, which the instant case expressly follows, it is, we submit, desirable that this Court should also consider the application of the pertinent statute and regulation to the facts presented by the instant cases.

Wherefore it is respectfully submitted that this petition should be granted.

STANLEY REED,
*Solicitor General.*

JULY 1936.

U. S. GOVERNMENT PRINTING OFFICE: 1936

# INDEX


| | Page |
|---|---|
| Opinions below | 1 |
| Jurisdiction | 2 |
| Question presented | 2 |
| Statutes and Regulations involved | 2 |
| Statement | 2 |
| Specification of errors to be urged | 4 |
| Summary of argument | 5 |
| Argument | 6 |
| Conclusion | 19 |
| Appendix A | 20 |
| Appendix B | 22 |


## CITATIONS


| | |
|---|---|
| **Cases:** | |
| *Brown* v. *Helvering*, 291 U. S. 193 | 19 |
| *Commissioner* v. *Charavay*, 79 F. (2d) 406 | 18 |
| *Commissioner* v. *Stevens*, 78 F. (2d) 713 | 17 |
| *Hall* v. *Commissioner*, 29 B. T. A. 1255 | 17 |
| *Hamill* v. *Commissioner*, 30 B. T. A. 955 | 19 |
| *Lucas* v. *Structural Steel Co.*, 281 U. S. 264 | 19 |
| *Schafer* v. *Commissioner*, 83 F. (2d) 317 | 17 |
| *Schafer* v. *Helvering*, Nos. 24, 25, and 26, October Term, 1936 | 6, 14 |
| *Seeley* v. *Helvering*, 77 F. (2d) 323 | 14 |
| *Vaughan* v. *Commissioner*, 85 F. (2d) 497 | 18 |
| **Statute:** | |
| Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 22 | 20 |
| **Miscellaneous:** | |
| Report of the Hughes Committee (appendix to *The Stock Exchange from Within* (1913 Edition), Van Antwerp | 8 |
| Report of the Securities and Exchange Commission on the Feasibility and Advisability of the Complete Segretation of the Functions of Dealer and Broker | 9, 11, 12, 13, 15, 16 |
| Rules of the Board of Governors of the New York Stock Exchange, Ch. XI, Secs. 1 and 2 | 11, 22 |
| S. Rep. 1455, 73d Cong., 2d Sess. (Report of the Senate Committee on Banking and Currency on Stock Exchange Practices) | 9, 13, 18 |
| Short Selling, Meeker | 9, 11 |
| Stock Market Theory and Practice (1930 Edition), Schabacker | 15 |




103575—36——1

Miscellaneous—Continued.


| | Page |
|---|---|
| Studies, Simpson | 13 |
| The Law of Stock Brokers and Stock Exchanges, Meyer | 11 |
| The New York Stock Exchange, Whitney | 11 |
| The Security Markets, Twentieth Century Fund, Inc | 8, 9, 12, 13, 16 |
| The Stock Exchange from Within (1913 Edition), Van Antwerp | 9 |
| The Stock Market (1934 Edition), Huebner | 8, 10, 11, 16 |
| The Work of the New York Stock Exchange (1930 Edition), Meeker | 8, 10, 16 |
| The Work of the Specialist, Hoffman | 8 |
| Treasury Regulations 74: | |
| ART. 105 | 20 |

# In the Supreme Court of the United States

OCTOBER TERM, 1936

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No. 186

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

ALBERT FRIED

---

No. 187

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BENJAMIN EINHORN

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*ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT*

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## BRIEF FOR THE PETITIONER

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### OPINIONS BELOW

The opinion of the Circuit Court of Appeals for the Second Circuit (R. 28–31) is reported in 83 F. (2d) 193. The opinion of the Board of Tax Appeals (R. 17–23) is reported in 31 B. T. A. 638.

## JURISDICTION

The judgments of the Circuit Court of Appeals were entered April 13, 1936 (R. 31). A petition for writs of certiorari was filed on July 13, 1936, and was granted October 12, 1936. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

Whether floor "specialists" on the New York Stock Exchange are dealers in securities within the meaning of Article 105 of Treasury Regulations 74, and as such entitled to make their return upon an inventory basis.

## STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in Appendix A, *infra*, pp. 20–21.

## STATEMENT

The facts in this case, as stipulated (R. 13–17), may be summarized as follows:

Respondents are the members of the co-partnership of Albert Fried & Company, a brokerage firm. The firm was organized in March 1929. During the taxable year in question—the fiscal year ending January 31, 1931—it maintained an office and a staff of employees at 120 Broadway, New York City. Respondent Fried's interest in the firm was 95 percent and respondent Einhorn's 5 percent (R. 14, 15).

Both partners are members of the New York Stock Exchange, and the firm itself, which is also a member, was a floor "specialist" in thirteen stocks traded on the Exchange. As such, the firm accepted orders in these thirteen stocks from other members for execution. The firm filled these orders by buying and selling the securities for its own account or by matching like orders of a buyer and a seller.[1] The firm leased space on the floor of the Exchange, where it regularly transacted this business; it held itself out generally as a specialist in these thirteen stocks, and it was known to all members of the Exchange as such (R. 14).

The customers of the firm were 431 in number. Each of them was a member of the Exchange, who was acting either for himself or his customers. The sales were in lots ranging from 100 to a maximum of 5,700 shares. On numerous occasions the partnership purchased and sold the securities in which it specialized in order to maintain fair and equitable markets, and as far as possible it tried to prevent wide fluctuation in these securities. It always had on hand the securities in which it specialized (R. 15–16).

Schedule 1 (R. 16) attached to the stipulation discloses that, at the end of each month of the taxable year in question, the partnership owned from a maximum of 62,300 down to a minimum of 10,300

[1] The firm's activities also included the purchase and sale of stocks (R. 14). These transactions are not here involved.

shares of the stocks in which it specialized (R. 15). On the other hand, Schedule 2 (R. 16–17) submitted with the stipulation as typical of its daily transactions in these stocks (R. 15) discloses that the amounts on hand and purchased in the two securities therein named substantially equalled the amounts sold. All stocks which it purchased and sold were actually delivered. (R. 15.) Since its inception in March 1929 (R. 18), the partnership regularly inventoried unsold securities on hand at market value, and in its tax returns computed its net income on the same basis (R. 15).

The Commissioner of Internal Revenue determined that the partnership was not a dealer in respect of the securities in which it specialized and denied the partnership the right to make its return of income for the taxable year in question upon the inventory basis. This determination resulted in a deficiency determination in the taxes of each respondent (R. 6–7, 11–12). A majority of the Board (four members dissenting) sustained the Commissioner's determination (R. 23–24). This decision was reversed by the court below on the authority of its decision in the case of *Commissioner* v. *Stevens*, 78 F. (2d) 718.

## SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the partners are dealers in securities so as to entitle them to the use of inventories in computing income.

2. In construing Section 22 (c) of the Revenue Act of 1928 as embracing the business of the partners.

3. In holding that the partners had shown themselves to be within the scope of Article 105 of Regulations 74.

4. In reversing the decision of the Board of Tax Appeals and remanding for further proceedings in accordance with its opinion.

## SUMMARY OF ARGUMENT

The Commissioner has by regulation authorized "dealers in securities" to make their return of income upon the inventory basis. The regulation defines such dealer as a "merchant" in securities with an established place of business, regularly engaged in the purchase of securities for their resale to customers. It specifically provides that taxpayers who buy and sell securities for investment or speculation are not within the meaning of the rule. The regulation envisages a merchant who keeps a stock of securities on hand at a regular place of business for sale to customers for their use and consumption and not a broker who, in executing the brokerage orders of other brokers at his "post" on the floor of the Exchange, purchases from as well as sells the same securities to them in cyclical recurrence or matches the buy or sell orders of different brokers. The specialist's "post" on the Exchange is not a "regular place of business," and the other members of the Exchange are not his "customers," within the meaning of the regulation.

It was stipulated that on numerous occasions the partnership purchased and sold the securities in which it specialized for its own account in order to maintain the market. It does not, however, appear what part of the balances on hand at the end of each month resulted from such purchases, nor that any part of them resulted from purchases made in order to maintain a stock of securities to meet customer demands. Purchases made by it for any other purpose could only have been made for resale at a profit on an anticipated rise of the market. In its transactions, the partnership was a trader and not a merchant. It merely speculated for small profits. The petitioners have not overcome the heavy burden resting upon them to show not only that the Commissioner's determination was erroneous, but that it was plainly arbitrary.

## ARGUMENT

Article 105 of Regulation 74 has been discussed at some length in the brief filed on behalf of the Commissioner of Internal Revenue in *Schafer* v. *Helvering*, Nos. 24–26, October Term, 1936. We there pointed out that the Article contemplates a *merchant* of securities with an established place of business who, like any other merchant, keeps on hand a stock in trade—in this case securities—which he replenishes from time to time with additional purchases in order to maintain on hand a supply sufficient to meet the expected demands of his customers.

The transactions of the Schafer Brothers firm, however, involved purchases of securities other than those in which it specialized. These securities were held by it for resale at a profit upon an anticipated or hoped for rise of the market. Such purchases and sales, we believe, were mere speculations and did not serve to classify that firm as a merchant. On the other hand, in the instant case, the purchases and sales of the respondents' firm were of securities in which it specialized. While the stipulation shows that the firm made some accumulations in such stocks, it fails to show what if any of them resulted from purchases which it made in the exercise of its specialist's functions. Since, however, some of these may have been made in the course of its business as a specialist—that is, in the performance of its functions as such—it will be necessary to consider such functions in some detail in order to show that a specialist on the New York Stock Exchange is not a merchant within the meaning of the regulation and should therefore not be permitted to make his return of income on the inventory basis.

The stipulation of facts describes in only meager outline the trade practices of the respondents' firm in carrying out its functions as a specialist. It does, however, state the salient fact that as such it filled the orders of other members by either purchasing or selling such stock for its own account or by matching like orders to purchase and sell (R. 14). The authorities on the functions and trade prac-

tices of the various members of the Stock Exchange furnish the same, though a more complete picture and one which we believe will be conducive to a better understanding of the subject in hand and therefore helpful to the Court in its determination of the question here presented.

Primarily, the specialist is a broker's broker, or a subbroker. As such, he executes orders of other members by buying or selling for them in the market the stock in which he specializes, just as the member who entrusts the order to him might himself do.[2] Under certain circumstances, however, he may execute these orders by purchasing the securities for his own account, or selling his own securities, as the case may be. It is this phase of the specialist's business which is relied upon by respondents to bring their firm within the limits of the phrase "dealers in securities." But these latter purchases and sales, in so far as they are made in connection with the specialist's functions, are generally asserted to be made chiefly in order to create and maintain a steady market.[3] Indeed,

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[2] See *The Work of the New York Stock Exchange*, by James E. Meeker, Economist of the New York Stock Exchange (1930 ed.) p. 212.

[3] *The Work of the Specialist*, by Dr. G. Wright Hoffman, being c. XII of *The Security Markets*, Twentieth Century Fund, Inc. (1935), p. 407 (a copy of this work may be found in the library of the Securities and Exchange Commission, Eighteenth Street and Pennsylvania Avenue, Washington, D. C.); *The Stock Market* (1934 Edition), by Dr. S. S. Huebner, pp. 55–56; The Report of the Hughes Committee, which is set out in full as an appendix to *The Stock Exchange*

this is the only reason disclosed by the stipulation for any of them[4] (R. 15). In other words, the specialist in this respect supplies an intermediate middleman variety of trading essential to the maintenance of a continuous, liquid market.[5] As was said in the Report of the Securities and Exchange Commission (Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, pursuant to Section 11 (e) of the Securities Exchange Act of 1934), p. 14:

> The dealings of specialists in the securities in which they are registered constitute floor

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*from Within* (1913 Edition), by William Clark Van Antwerp, pp. 415, 426; *Short Selling*, Meeker, pp. 33, 102; and the Report of the Committee on Banking and Currency of the United States Senate on Stock Exchange Practices, being S. Rep. 1455, 73d Cong., 2d Sess., which states (p. 26), that the chief argument advanced in favor of permitting the specialist to trade for his own account is that such trading enables him to maintain a close and orderly market.

[4] Another reason for making such purchases and sales in connection with the specialist's functions adverted to by the authorities is to enable him to minimize his losses in the event of error on his part in the execution of an order or the insolvency of a customer. See the Report of the Securities and Exchange Commission on the Feasibility and Advisability of the Complete Segregation of the functions of Dealer and Broker made on June 20, 1936, pursuant to Section 11 (e) of the Securities Exchange Act, 1934, pp. 38–40, 42, 87. However, the stipulation does not mention this reason at all and, in any event, such transactions do not qualify the specialist as a merchant.

[5] See *The Security Markets*, Twentieth Century Fund, Inc., *supra*, p. 426.

> trading, as do also the transactions effected by all other members for their own account while on the floor.

With obviously the same thought in mind, Mr. Meeker points out (*The Work of the New York Stock Exchange* (1930 ed.)), p. 105, that when a new issue has once been "seasoned," the whole floating supply (which is the current surplus over investment demand, *op. cit.* p. 107)—

> continues to be sustained at all times by all the speculators in the market, including the floor trader, the specialist, the odd-lot dealers, and the speculating customers of commission houses.[6]

Clearly, the specialist is not here performing the function of *distribution,* but rather that of making a market. The process is described by Mr. Meeker as "a constant 'churning'" (*Op. cit.* p. 105). Thus, we have here an all but closed circular movement which results from purchases and sales of blocks of the same stock in cyclical recurrence from and to the same persons, everyone concerned being interested only in the profit that he may make upon a resale of the stock. This characterizes the business of making a market, and is not the straight-line transaction which is the essence of merchandising.

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[6] See to the same effect the excellent discussion of the meaning of a "continuous market," in *The Stock Market,* Huebner, *supra,* pp. 24 *et seq.*

Furthermore, the purchases and sales which the specialist makes for his own account are subject to an important restriction imposed by the rules of the Exchange, not in the very nature of things imposed upon any merchant. The specialist is forbidden to act as a broker and dealer in the same transaction. (See Chap. XI, Secs. 1 and 2 of the Rules of the Board of Governors of the New York Stock Exchange, set out in Appendix B, *infra,* pp. 22–23.) That is to say, he may not purchase or sell for his own account when he has an order to buy or sell for a customer; nor may he do so unless he first endeavors to purchase or sell the securities in the open market at an eighth lower or higher, as the case may be, than his own bid. In no event may he buy or sell unless the price is justified by the conditions of the market and the transaction is ratified by the member who gave him the order.[7] And when he does purchase or sell for his own account he merely trades with his "book," which

[7] See the Report of the Securities and Exchange Commission, *supra*, p. 8, especially note 46 on that page; also page 33 where, *inter alia*, the reasons for the inadequacy of this rule to protect the public are stated; also *The New York Stock Exchange*, an address in pamphlet form by Mr. Richard Whitney, president of the New York Stock Exchange (a copy of which may be found in the library of the Securities and Exchange Commission); *The Stock Market*, Huebner, *supra*, pp. 178–179; and *Short Selling*, Meeker, *supra*, pp. 33–34. The customer may also repudiate. *The Law of Stock Brokers and stock Exchanges*, Meyer, pp. 282–283, 487–488.

he is permitted to do. Incidentally, this enables him to make new highs and lows, to remove offerings and bids from the market, or merely to draw public attention by simply "churning" the market.[8] Thus there can be no doubt that these operations are at best incidental to the specialist's broker's-broker functions. Indeed they are said to constitute an important adjunct to his brokerage business;[9] in that they assist other members in executing their orders at a fair price, with the result that the specialist is rewarded by increased commission business.[10] This does not present the picture of a merchant.

It was not stipulated that it was necessary for the partnership to make purchases, or that it did in fact make them, in order to maintain on hand a stock of securities to meet customer demands. Undoubtedly the reason is that the conditions under which purchases and sales are made by specialists clearly indicate that no such necessity or purpose exists.

In other words, the specialist does not, as a regular thing, have or need long positions in any of the securities in which he specializes. To the contrary, the conclusion is inescapable that his ideal position

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[8] Report of the Securities and Exchange Commission, *supra*, p. 34.

[9] See *The Security Markets*, Twentieth Century Fund, Inc., *supra*, p. 406.

[10] See Report of Securities and Exchange Commission, *supra*, pp. 40–41; also the Report of The Committee on Banking and Currency of the United States Senate, *supra*, p. 25.

is to have nothing on the shelf, so to speak. This is the conclusion that has been reached by authorities on Exchange practices. For example, it is said in the Report of the Securities and Exchange Commission, *supra* (p. 33) that "Since the specialist under ordinary circumstances is willing to trade either as buyer or seller, his purchases and sales may be expected to be chiefly of an in-and-out character which tend to balance each other over brief periods."[11] The Report states that this view is not only generally confirmed by the specialists themselves, but by the tabulations of purchases and sales over the 25-week period investigated by the Commission, which is appended to the Report. This discloses that, more often than not, the specialists' weekly sales exceeded their purchases; that is, they had sold short. Schedule 2 attached to the stipulation in the instant case (R. 16–17), which was stipulated to be "a typical picture of the daily business done by the firm in the stocks in which it specializes" (R. 15), shows that the partnership's

[11] To the same effect see the Report of the Committee on Banking and Currency of the United States Senate, *supra*, p. 20; Dr. Kemper Simpson's *Studies*, [redacted], pp. 69–73; and particularly *The Security Markets*, Twentieth Century Fund, Inc., *supra*, p. 419, where it is said:

"The striking feature of the personal trading of specialists is the extent to which their purchases and sales balance for each group each week. The amount of position assumed during any one of these periods or groups is comparatively small in relation to the volume of trading done."

tradings were precisely of such daily in-and-out character.[12]

As already noted, the stipulation does not account for the large balances of stock which the partnership had on hand at the end of each month as shown in Schedule 1 (R. 16). There is not even an affirmative statement therein that they resulted entirely from the partnership's efforts to maintain the market. In any event, it cannot be assumed that the securities were accumulated and kept on hand to fill its brokerage orders. In so far as they may have been acquired for any other purpose, they could only have been intended for resale at a profit upon an expected rise of the market, as was done by the Schafer Bros. firm in the case of *Schafer* v. *Helvering, supra.*

On page 18 of our brief in the *Schafer* case we pointed out that the function of the specialist differs from that of the floor trader in several respects. Nevertheless, we believe that the purchases of the specialist for his own account in the securities in which he specializes are essentially no less speculative than those of the floor trader, who for this reason was denied the privilege of making a return of his income upon the inventory basis. *Seeley* v. *Helvering,* 77 F. (2d) 323. As was pointed out in the report of the Securities and Exchange Commis-

[12] It will be noted that no segregation is made between transactions representing the execution of orders for other members in the market and those representing their execution by purchases and sales for the partnership's own account.

sion, *supra* (p. 14), the dealings of the specialist in the securities in which he specializes constitute floor trading, as do the transactions effected by all other members for their own account while on the floor, and that (p. 17) it is generally conceded floor trading is essentially speculative in character, members ordinarily trading at frequent intervals and profiting from comparatively small price fluctuations.

Not only does respondents' firm lack the essential attributes of a merchant, but it also fails to meet the requirements of Article 105 that it must have "an established place of business" and "customers." The regulation, we submit, contemplates a place of business where merchandise is stocked for sale and persons go there to purchase. If this be true, the "post" [13] leased by the firm on the floor of the Exchange where, as stipulated (R. 15), it transacted its specialist business, was not such a place of business, and the brokers who came there were not customers.[14] No one goes to the specialist's post except other members of the exchange, and then not in expectation of buying securities

[13] For a description of the specialist's "post" see *Stock Market Theory and Practice* (1930 Edition), by R. W. Schabacker, financial editor of Forbes Magazine, pp. 29–30.

[14] It was further stipulated that the firm maintained an office at 120 Broadway with a staff of eight people employed to deliver securities and keep records, in addition to the two partners. (R. 15.) But it will hardly be contended that this was where it conducted its specialist business.

from a stock which is there kept on hand for sale at a price that the specialist has put upon them, but only to entrust him with the execution of their brokerage orders for their customers at market, or upon such condition as they may specify, which more often than not contemplates a rise or a fall in the market in the future.[15] The reason the other members place such orders with the specialist is that he is usually willing to make a market for them by buying the stock offered, or selling it if he has already purchased it, or by selling it short. His services are sought particularly in respect of orders which cannot be executed directly at the then current market, or are difficult to execute because of the inactivity or intense activity of the stock in question.[16] We submit that the specialist cannot be called a merchant, and, by the same token, he has no customers or place of business in the sense that a merchant has, and in the sense

[15] Most of the specialist's orders are said to be limited-price orders, which are orders to buy or sell at a fixed price or a better price if obtainable. See the Report of the Securities and Exchange Commission, *supra*, pp. 26, 33. He also executes "stop-loss orders." See *The Security Markets*, Twentieth Century Fund., Inc., pp. 232, 403. A stop-loss order is one to buy or sell at a stated amount at market if and when a transaction occurs at that price. See the Report of the Securities and Exchange Commission, *supra*, p. 26.

[16] See e. g., *The Stock Market*, Huebner, *supra*, p. 178; *The Work of the New York Stock Exchange*, Meeker, *supra*, pp. 212–213; *The Security Markets*, Twentieth Century Fund, Inc., pp. 232, 406.

contemplated by Article 105. See *Schafer* v. *Commissioner,* 83 F. (2d) 317, 319, now pending as Nos. 24–26, October Term, 1936.

The decision of the lower court in the instant case rests solely upon the authority of its own decision in the case of *Commissioner* v. *Stevens,* 78 F. (2d) 713, which affirmed the decision of the Board of Tax Appeals reported *sub nom. Estate of Harry E. R. Hall* v. *Commissioner,* 29 B. T. A. 1255, since, as it said, it could find no material difference whatever between that case and this, and believed that the facts here brought it within its decision in the *Stevens* case. The lower court in that case concluded that the dealings of the firm of Stevens & Legg, whose transactions were there involved, could not be said to be speculative only, saying (p. 714):

> The firm held at all times large blocks of stock which it sold in small lots to its various customers, numbering at least one hundred, at different times, and it sold at different prices. *It bought additional blocks of stock with which to replenish its supply.* At all times it had shares of the stock to be sold for profit or loss, as the case may be, on resale. *This was its wares or stock in trade.*

We think that the error of the court in both cases lies in the fact that it assumed that the firm in each bought additional stocks with which to replenish its supply and that this was its wares or stock in

trade.[17] And in the more recent case of *Vaughan* v. *Commissioner,* decided August 10, 1936, 85 F. (2d) 497, the court below went so far as to say that as specialists the petitioners there were required *by the practice* of the New York Stock Exchange to have on hand a supply of the stocks in which they dealt so as to round out orders in cases where the bid and asked prices did not match and to make deliveries where they were selling stocks to maintain a market. We know of no such requirement. Of course, the specialist must make deliveries if he sells stock, whether it be in order to maintain the market or for any other purpose, and in order to do so he must have the stock in his possession, or get it if he has sold it short. But, he is under no obligation to sell "where the bid and asked prices do not match," that is, in order to make a market under such circumstances.[18] It is submitted that the lower court in these cases labored under a complete misapprehension not only as to the functions and trade practices of the specialist, but as to the rules governing them.

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[17] The same decision of the Board was affirmed by the Circuit Court of Appeals for the Third Circuit *sub. nom. Commissioner* v. *Charavay*, 79 F. (2d) 406, which proceeded upon the ground that the controlling factor "is not the method by which the partnership obtained customers or made sales," but "it is the fact that the partnership purchased securities and held them not for investment or speculation, but for resale at a profit to anyone who desired to buy."

[18] See the Report of the Committee on Banking and Currency of the United States Senate, *supra*, p. 26.

The respondents have the heavy burden of establishing that the Commissioner's action in denying them the use of inventories was not only erroneous but plainly arbitrary. *Lucas* v. *Structural Steel Co.*, 281 U. S. 264; *Hamill* v. *Commissioner*, 30 B. T. A. 955. As we pointed out in the Government's brief in the *Schafer* case, *supra*, if it were otherwise, the Court would be concerning itself merely with the relative merits of accounting, which, as this Court has said, is not within its province. *Brown* v. *Helvering*, 291 U. S. 193, 204–205. We submit that this burden has not been met merely by showing that the partnership purchased and sold some, or even all, of the securities in question in the performance of its functions of a specialist.

## CONCLUSION

The decision of the lower court should be reversed.

Respectfully submitted.

STANLEY REED,
*Solicitor General.*
ROBERT H. JACKSON,
*Assistant Attorney General.*
SEWALL KEY,
CARLTON FOX,
CHARLES A. HORSKY,
*Special assistants to the Attorney General.*

November 1936.

## APPENDIX A

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treasury Regulations 74:

ART. 105. *Inventories by dealers in securities.*—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either—

(a) At cost;

(b) At cost or market, whichever is lower; or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation,

with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

# APPENDIX B

## Rules of the Board of Governors of the New York Stock Exchange, Chapter XI

### Members dealing for their own account

Sec. 1. No member, while acting as a broker, whether as a specialist or otherwise, shall buy or sell directly or indirectly for his own account or that of a partner, or for any account in which either he or a partner has a direct or indirect interest, securities the order for the sale or purchase of which has been accepted by him or his firm or a partner for execution; except as follows:

(Exception (a).) A member who, by reason of his neglect to execute an order, is compelled to take or supply on his own account, the securities named in the order, is not acting as a broker, and shall not charge a commission;

(Exception (b).) A member may only take the securities named in the order, provided he shall have offered the same in the open market, if bonds at ⅛ of 1%, and if stocks at ⅛ of one dollar, higher than his bid, and provided the price is justified by the condition of the market, and that the member who gave the order shall directly, or through a broker authorized to act for him, after prompt notification, accept the trade and report it;

(Exception (c).) A member may only supply the securities named in the order, provided he shall have bid for the same in the open market, if bonds

at ⅛ of 1%, and if stocks at ⅛ of one dollar, lower than this offer, and provided the price is justified by the condition of the market, and provided that the member who gave the order shall directly, or through a broker authorized to act for him, after prompt notification, accept the trade and report it;

(Exception (d).) A member, acting as a broker, is permitted to report to his principal a transaction as made with himself when he has orders from two principals to buy and to sell and not to give up, such orders being executed in accordance with Section 13 of Chapter I, in which case he must add to his name on the report the words "on order."

SEC. 2. When a member either takes the book of a specialist temporarily or an order from another member, he shall, while he is in possession of that book or order and for the balance of that particular day, stand in the same relation to the book or order as the specialist or other member himself.

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CHARLES ELMORE CR
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IN THE

# Supreme Court of the United States

October Term, 1936.

Nos. 186 - 187

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

ALBERT FRIED

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BENJAMIN EINHORN

*On petition for writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit*

## BRIEF FOR THE RESPONDENTS IN OPPOSITION

JOHN J. CURTIN,
Counsel for Respondents.

# INDEX


| | PAGE |
|---|---|
| Opinions Below | 1 |
| Jurisdiction | 2 |
| Question Presented | 2 |
| Statute and Regulations Involved | 2 |
| Statement | 4 |
| Argument | 6 |
| Conclusion | 11 |


## CITATIONS

CASES:


*Commissioner* v. *Stevens*, 78 F. (2d) 713 ..... 6

*Schafer* v. *Helvering*, 83 F. (2d) 317 .....6, 9, 10

*Vaughan* v. *Commissioner* decided August, 1936 8, 9

*Commissioner* v. *Charavay*, 79 F. (2d) 406 .... 6, 8


STATUTE:


Revenue Act of 1928, c. 852, 45 Stat. 791:
Sec. 22 ..... 2


MISCELLANEOUS:


Treasury Regulations 74:
Art. 105 ..... 3

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*On petition for writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit*

---

## BRIEF FOR THE RESPONDENTS IN OPPOSITION

---

### Opinions Below

The opinion of the United States Board of Tax Appeals (R. 34-46) is reported in 31 B. T. A. 130. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 59) is reported in 83 Fed. (2nd) 193.

## Jurisdiction

The judgments of the Circuit Court of Appeals were entered April 13, 1936. The cases were consolidated and involve the same question and the same facts. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## Question Presented

Whether the partnership of Albert Fried & Co. was a dealer in securities in which it specialized and as such entitled to inventory such securities at market value in determining net income.

## Statute and Regulations Involved

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 22. GROSS INCOME.

* * * * * * * *

(c) *Inventories*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * * * * *

Treasury Regulations 74:

ART. 105. *Inventories by dealers in securities*—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either

(a) At cost;
(b) At cost or market, whichever is lower; or
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may make his return upon the basis upon which his accounts are kept; provided that a description of the methods employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

## Statement

All of the facts were stipulated (R. 27-31).

The respondents are members of the partnership firm of Albert Fried & Co. Each of the partners owned a membership on the New York Stock Exchange, where floor space was leased for the transaction of the firm's business. The firm also maintained an office in New York City (R. 28).

The firm was a specialist in thirteen stocks traded in on the exchange (R. 28). It always had on hand the securities in which it specialized, and during the fiscal year ending January 31, 1931, the year involved here, its supply ranged from 10,300 shares at the end of one month to 62,300 shares at the end of another (R. 29-30).

*"The firm held itself out generally and was known to all of the members of the exchange as the specialist in these thirteen stocks, and it was regularly and consistently engaged in the purchase and resale of such securities"* (R. 29). (Italics ours.)

Its customers were other members of the Exchange acting for themselves or as brokers, and during the taxable year the firm sold its specialties to 431 of these members and the sales ran from a minimum of 100 shares to a maximum of 5,700 shares. All the stocks which the firm bought and sold were actually received and delivered by it (R. 30-31).

Ever since its inception the firm has regularly inventoried in its books of account its unsold securities on hand at market value, and in its income tax returns it has computed its net income on the same basis (R. 31).

The Government further stipulated that "Of the 126,200 shares of Air Reduction sold on the Exchange in one month, 59% was sold by the firm. Of a total of 328,700 shares of Northern Pacific sold on the Exchange in one month 45% represented shares sold by the firm" (R. 30).

The firm obviously did not acquire and own such large blocks of stock (R. 32) for speculation. The firm carried a preponderance of and was a dominant factor in the stocks in which it specialized.

The Government further stipulated that on numerous occasions the partnership purchased and sold the securities in which it specialized in order to maintain fair and equitable markets and as far as possible to prevent wide fluctuations in price on such securities (R. 31). Sales of the firm were not occasional but were regular, frequent and substantial in amount (R. 30).

There is no proof in the record that the purchases made by the firm in the stocks in which it specialized were for either investment or speculation and no such inference can be drawn, on the contrary the volume of business conducted by the firm and the position taken by the firm in the securities detailed in the stipulation of facts is convincing and establishes that the firm as a specialist in the thirteen securities enumerated *dealt* in and did not trade or speculate in such securities.

In determining the tax liabilities of the respondents for the year here in question, the Commissioner denied their contention that the firm was entitled to inventory stock as a dealer in securities, and accordingly asserted deficiencies against the respondents (R. 9, 11; 21, 23). The Board of Tax Appeals by a divided vote approved the Commissioner's action (R. 44) but the Circuit Court

of Appeals for the Second Circuit reversed the Board, remanding the cases for further proceedings in accordance with its opinion (R. 59).

## Argument

The sole ground for the application for the writs of certiorari is the alleged conflict of the decisions of the Circuit Court in *Commissioner* v. *Stevens,* 78 F. (2d) 713, which the present case expressly follows, and *Schafer* v. *Helvering,* 83 F. (2d) 317, decided by the Court of Appeals for the District of Columbia, in which latter case this Court granted writs of certiorari (Nos. 24, 25 and 26, October Term 1936).

The Court of Appeals for the District of Columbia in the Schafer case was unable to distinguish between the facts in that case and the Stevens case and *Commissioner* v. *Charavay* (C. C. A. Third Circuit 79 F. [2d] 406). The Government however opposed the certiorari in the Schafer case, taking the position that the Schafer case did not conflict with the Stevens and the Charavay cases, and in doing so emphatically and decisively showed the wide differences in the facts of both such cases. *The Government* in its brief opposing the application for the writ of certiorari in the Schafer case so clearly expresses the views of the taxpayers in the instant case that it is quoted at length:

> "The Stevens and Charavay cases were part of the same proceeding involving the brokerage firm of Stevens and Legg, and were considered by the Board of Tax Appeals sub nom. Estate of Harry E. R. Hall, 29 B. T. A. 1255. The Board's opinion in that case reveals that the firm of Stevens

and Legg was a 'specialist' on the New York Stock Exchange in some fourteen securities. As such, it held itself out as a dealer in those securities. At all times it carried a sufficient stock of them on hand to supply the demands of its customers, who numbered 101, and who made 268 separate purchases of its stocks during the taxable period. Its floor member occupied a regular post on the floor of the exchange, where he always stood ready to buy or sell. The firm's sales were large and to meet the demands it kept on hand a large supply of the stocks which it constantly replenished through purchases.

"This brief summary reveals the wide difference between the facts of that case and those of the present one. The purchases made by the Schafer firm were not to replenish a stock in trade, but were rather, as the Board found (R. 35), independent of the customers of the firm, and were made in expectation of a rise in the market price and for resale to anyone at a profit to the firms' account. The firm did not sell to and buy from brokers *as a merchant,* as did Stevens and Legg; it purchased and sold as a speculator. Moreover, in cases involving facts quite similar to the present ones both the Second and Third Circuit Courts of Appeal have recently denied the inventory privilege to speculators, with opinions which reveal their agreement with the principles laid down by the opinion in the instant case. Seeley v. Helvering, 77 F. (2d) 323 (C. C. A. 2d); Hammitt v. Commissioner, 79 F. (2d) 494 (C. C. A. 3d).

The Court of Appeals further found in the instant case that there was no material difference between the instant case and the Stevens case.

In the Stevens case, in the Charavay case, in *Vaughan v. Commissioner,* decided by the Second Circuit Court of Appeals August, 1936 (not yet reported) and in the instant case, the Court of Appeals found that the taxpayers were *specialists*, whereas in the Schafer case the Court found that the taxpayer was a *speculator.* In each case decided to date by the Circuit Courts a "specialist" was held to be a dealer and therefore entitled to inventory his securities in the computation of his tax return.

The Court of Appeals for the Second Circuit in the Vaughan case defined a specialist as follows:

> "A specialist is one who, having a position at a designated 'post' on the floor of the Exchange, maintains a book in which he enters all offers and bids for the stocks in which he specializes, thus indicating the 'market' for the stocks. The offers and bids are ordinarily made by other members of the Exchange. But the specialist is required to be ready at the demand of other brokers to quote the market price and to buy and sell at the closest fluctuations possible. Where the 'bid' and 'asked' prices furnished by the brokers coincide and the transaction is thereby effected, the specialist acts as a broker in the transaction. But where there is too wide a 'spread' between the 'bid' and 'asked' prices, in order to create a market, he either buys or sells the stock for his own account. Thus he becomes the owner of any stock acquired in this way * * *"

The Court further said:

> "We think that under the regulations Vaughan and the firm of Vaughan & Co. were 'dealers' in the

> five stocks in which they acted as specialists. As specialists they were required by the practice of the New York Stock Exchange to have on hand a supply of the stocks in which they dealt, so as to round out orders in cases where the bid and asked prices did not match, and to make deliveries where they were selling stocks to maintain a market."

We firmly believe that had Schafer established that he was a "specialist" the Court of Appeals of the District of Columbia would not have disagreed with the Second Circuit Court of Appeals. However, as Schafer was not a "specialist" and was found by the Court to be a "speculator" he was not entitled to inventory his securities, and therefore there is no conflict, upon analysis, between the Schafer case and the Stevens case or the instant case.

While the Court of Appeals of the District of Columbia in the Schafer case stated that the facts in the Stevens and Charavay cases were indistinguishable from the Schafer case nevertheless in its opinion the Court shows the distinguishable elements in these cases:

> "* * * Petitioners have an established place of business and held themselves out to their customers as authorized and qualified to buy or sell for them, as broker, shares of stocks and bonds; but there is *not a word of evidence that they likewise hold themselves out as having on hand securities for sale on their account, or that they personally or through salesmen carry on the business of selling their own securities to their own customers.*" (Italics ours.)

Further, the Court said:

> "* * * The element of resale *to customers—i. e.*, people who regularly or repeatedly deal with them—necessitates both possession of the thing to be sold and customers to sell it to. In the present case the last element is wholly lacking. Petitioners never had in mind disposing of their securities to their partnership's customers."

On the other hand, in the instant case the Government stipulated the following (R. 29-30):

> "10. The firm held itself out generally and was known to all of the members of the Exchange as the specialist in these thirteen stocks, and it was regularly and consistently engaged in the purchase and resale of such securities."
>
> "12. The firm always had on hand the securities in which it specialized. Schedule 1 attached herewith shows the number of shares of these stocks owned by the firm at the end of each month in the year under review. As shown in this schedule the shares carried ran from 10,300 shares at the end of one month to 62,300 at the end of another."

The foregoing facts it is contended by the taxpayers precludes the Government from now claiming that the cases are indistinguishable or that the decisions are in conflict, as the stipulation of facts overcomes the criticism pointed out by the Court in its opinion in the Schafer case and contains the very elements specifically stated by the Court to be lacking in the Schafer case to constitute the taxpayer a dealer in securities.

We therefore contend that the wide difference in the facts in such cases justifies different opinions, conclusions and determinations.

## Conclusion

We submit that the decisions on the question involved are not in conflict and that the instant cases do not present a question which warrants review by this Court. The petition should be denied.

Respectfully submitted,

JOHN J. CURTIN,
Counsel for Respondents.

# INDEX


| | PAGE |
|---|---|
| Opinions Below | 1 |
| Jurisdiction | 2 |
| Question Presented | 2 |
| Statute and Regulations Involved | 2 |
| Statement | 3 |
| ARGUMENT: | |
| The respondents meet all the elements contained in Article 105, Regulations 74 of the Revenue Act of 1928 | 5 |
| The controlling authorities in the lower Court uphold the respondents' contention that they are dealers in securities | 9 |
| Albert Fried & Company were entitled to inventory their securities since they regularly inventoried unsold securities on hand at market, and in its income tax returns for 1929, 1930 as well as 1931, computed its net income at market prices | 11 |
| Conclusion | 12 |


TABLE OF CASES CITED


Commissioner v. Charavay, Circuit Court of Appeals, Third Circuit, 79 F. (2d) 406 ..... 9

Commissioner v. Stevens, 78 F. (2d) 713 ..... 6, 9, 12

Estate of Harry E. R. Hall v. Commissioner, 29 B. T. A. 1255 ..... 9, 12

Harriman v. Commissioner, 43 Fed. (2d) 950 ..... 10

Schafer v. Helvering, 83 F. (2d) 317 ..... 9, 11

Seeley v. Commissioner, 77 Fed. (2nd) 323 ..... 11

Vaughan v. Commissioner, decided August 10, 1936 7, 9

PAGE

Revenue Act of 1928, c. 852, 45 Stat. 791 ..... 2

Treasury Regulations 74, Article 105 ..... 2

MISCELLANEOUS

Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, page 25 ..... 5, 7

Security Exchange Act (see Section 11, Item b) 8

Webster's New International Dictionary ..... 6

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1936

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NOS. 186, 187

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

ALBERT FRIED

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BENJAMIN EINHORN

---

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

---

## BRIEF FOR THE RESPONDENTS IN OPPOSITION

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### Opinions Below

The opinion of the United States Board of Tax Appeals (R. 19-23) is reported in 31 B. T. A. 638. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 29-31) is reported in 83 Fed. (2nd) 193.

## Jurisdiction

The judgments of the Circuit Court of Appeals were entered April 13, 1936. The cases were consolidated and involve the same question and the same facts. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## Question Presented

Whether the partnership of Albert Fried & Co. was a dealer in securities in which it specialized, under Article 105, Regulations 74, and as such entitled to inventory such securities at market value in determining net income (R. 14).

## Statute and Regulations Involved

Revenue Act of 1928, c. 852, 45 Stat. 791:

Sec. 22. GROSS INCOME.

* * * * * * * * *

(c) Inventories—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * * * * * *

Treasury Regulations 74:

ART. 105. Inventories by dealers in securities—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either

(a) At cost;

(b) At cost or market, whichever is lower; or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the methods employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities are not dealers in securities within the meaning of this rule.

## Statement

All of the facts were stipulated (R. 13-17).

The respondents are members of the partnership firm of Albert Fried & Co. Each of the partners owned a membership on the New York Stock Exchange, where floor space was leased for the transaction of the firm's business. The firm also maintained an office at 120 Broadway in New York City (R. 14).

The firm was a specialist in thirteen stocks traded in on the exchange. It always had on hand the securities in which it specialized, and during the fiscal year ending January 31, 1931, the year involved here, its supply ranged from 10,300

shares at the end of the month to 62,300 shares at the end of another (R. 14-15).

The firm held itself out generally and was known to all of the members of the exchange as the specialist in these thirteen stocks, and it was regularly and consistently engaged in the purchase and resale of such securities (R. 14-15).

Its customers were other members of the Exchange acting for themselves or as brokers, and during the taxable year the firm sold its specialties to 431 of these members and the sales ran from a minimum of 100 shares to a maximum of 5,700 shares. All the stocks which the firm bought and sold were actually received and delivered by it (R. 15).

Sales of the firm were not occasional but were regular, frequent and substantial in amount (R. 15).

For the year under review the firm sold 1,762,100 shares of the thirteen stocks in which it specialized amounting to $125,232,632.36 (R. 15).

Ever since its inception (in accordance with the practice of the New York Stock Exchange and the respondents interpretation of the rulings of the Commissioner of Internal Revenue) the firm has regularly inventoried in its books of account its unsold securities on hand at market value, and in its income tax returns it has computed its net income on the same basis (R. 15), and paid its tax on such basis, and notwithstanding said fact in the year 1931 the Commissioner for the first time denied their right to inventory their stock as a dealer in securities, and accordingly asserted deficiencies against the respondents (R. 6-7; 11-12).

The Board of Tax Appeals by a divided vote approved the Commissioner's action (R. 23) but the Circuit Court of Appeals for the Second Circuit reversed the Board, remanding the cases for further proceedings in accordance with its opinion (R. 29-31).

## ARGUMENT

### The respondents meet all the elements contained in Article 105, Regulations 74 of the Revenue Act of 1928.

If the respondents meet the requirements set forth by the Commissioner of Internal Revenue in his regulations under Article 105, the respondents must be classified as dealers in securities and have the right to inventory their securities under Section 22 of the Revenue Act of 1928. The respondents contend that they meet each and every one of the requirements set forth in Article 105, as follows:

(a) They have an established place of business.

(b) They are regularly engaged in the purchase of securities and their resale to customers.

(c) * * * That is one who as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. * * *

(a) *They have an established place of business.*

The established place of business is the post at which the respondents are stationed on the floor of the New York Stock Exchange, for the purpose of buying and selling securities in which they specialize, and for which they pay a rental of $2,000 a year.

> "9. The firm leased space on the floor of the Exchange where it transacted its business in the thirteen stocks in which it specialized. The annual rental for this space is $2,000.00" (R. 14).

To this post all brokers wishing to buy or sell the securities in which the respondents specialize come.[1] In addition to

---

[1]In contrast to other members of the exchange who move about freely, the specialist is stationed at a fixed post on the trading premises. (From Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, page 25.)

the post on the floor of the Exchange the respondents have an office at 120 Broadway, New York City, where the receipts and deliveries of the stocks purchased and sold are made.

(b) *They are regularly engaged in the purchase of securities and their resale to customers.*

The stipulated facts admit that the respondents were regularly and consistently engaged in the purchase and resale of the securities in which they specialize (R. 14).

The customers of the respondents were the other members of the New York Stock Exchange, acting for themselves or acting as brokers for the general public (R. 16).

*Commissioner* v. *Stevens*, 78 F. (2d) 713.

"Another broker may well be considered a customer. Indeed, unless the firm was a dealer in securities, members of the Stock Exchange who purchased securities from it and who were its customers, could have bought the stock in the open market instead of buying from them."

(c) * * * *That is one who as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.* * * *

The respondents were merchants dealing in the securities in which they specialized.

"The term 'merchant' * * * includes 'any one making a business of buying and selling commodities,' 'a trafficker,' 'trader' or 'one who trafficks on a large scale.'" Webster's New International Dictionary.

A specialist on the New York Stock Exchange functions both as a broker and as a dealer.

Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, made on June 20, 1936, Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, page 25, item 4 (a) gives the function of the specialist as follows:

> "a. Functions of the Specialist.
>
> The specialist characteristically combines the functions of broker and dealer. As a broker he effects transactions for the account of other members and their customers in a particular stock or group of stocks in which he is registered as a specialist. As a dealer he effects transactions for his own account in such stock or stocks. In contrast to other members of the exchange who move about freely, the specialist is stationed at a fixed post on the trading premises. Every stock dealt in on the New York Stock Exchange has at least 1 specialist; stocks which enjoy considerable trading activity have as many as 6 competing specialists; and some specialists handle as many as 50 stocks.
>
> The specialists occupy the pivotal position in the market for the stocks in which they specialize. As buyers and sellers for their own account or as agents in the execution of orders for others, specialists actually purchase and sell a substantial percentage of all stock traded in on the exchange and actually participate in a great majority of all trades. Even with respect to those transactions in which they are not parties, their bids and offers serve as standards for the appraisal of the market by others."

The Circuit Court of Appeals for the Second Circuit in *Vaughan* v. *Commissioner,* decided August 10, 1936, not yet reported, defined a specialist as follows:

> "A specialist is one who, having a position at a designated 'post' on the floor of the Exchange, maintains a book in which he enters all offers and bids for the stocks in which he specializes, thus indicating the 'market' for the stocks. The offers and bids are ordinarily made by other members of the Exchange. But the specialist is required to be ready at the demand of other brokers to

quote the market price and to buy and sell at the closest fluctuations possible. Where the 'bid' and 'asked' prices furnished by the brokers coincide and the transaction is thereby effected, the specialist acts as a broker in the transaction. But where there is too wide a 'spread' between the 'bid' and 'asked' prices, in order to create a market, he either buys or sells the stock for his own account. Thus he becomes the owner of any stock acquired in this way."

The dealer function of the specialist is definitely recognized in the Security Exchange Act (see Section 11, Item b).

"If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market."

The respondents were admittedly specialists of the New York Stock Exchange (R. 14).

"5. The firm is a specialist in the following thirteen stocks traded in on the Exchange:

Northern Pacific Railway, common stock.
Air Reduction Co., common stock.
United Carbon Co., common stock.
American Zinc & Lead Smelting & Refining Co., common stock.
American Zinc & Lead Smelting & Refining Co., preferred stock.
Davega Stores Co., common stock.
A. Hollander & Sons, common stock.
Minnesota Moline Power Implement Co., common stock.
Minnesota Moline Power Implement Co., preferred stock.
Poor & Co. common stock.
Sterling Securities Co., A stock.
Sterling Securities Co., preference preferred.
Sterling Securities Co., convertible preferred.

To further illustrate that the respondents were merchants we refer to the stipulation of facts (R. 15) wherein it is conceded that the firm had an established place of business and always had on hand the securities in which it specialized and carried from 10,300 shares at the end of one month to 62,300 shares at the end of another month, and that it traded in 1,762,100 shares of the thirteen stocks in which it specialized, the selling price of these shares amounting to $125,232,632.36.

**The controlling authorities in the lower Court uphold the respondents' contention that they are dealers in securities.**

The respondents rely upon the decisions in *Estate of Harry E. R. Hall* v. *Commissioner,* 29 B. T. A. 1255. *Commissioner* v. *Stevens,* Circuit Court of Appeals, Second Circuit, 78 F. (2d) 713, *Commissioner* v. *Charavay,* Circuit Court of Appeals, Third Circuit, 79 F. (2d) 406, *Vaughan* v. *Commissioner,* Circuit Court of Appeals, Second Circuit, decided August 10, 1936, not yet reported.

In each of the above authorities the courts below have held that a specialist on the floor of the New York Stock Exchange was a dealer and as such entitled to inventory his securities.

The only case in apparent conflict with the above authorities is *Schafer* v. *Helvering,* 83 F. (2d) 317, in which the Circuit Court of Appeals for the District of Columbia held that the taxpayer was a speculator and not a dealer in securities.

The transactions in the Schafer case, however, involved purchase and sales of securities *other than those in which that firm specialized.*

In the instant case, as in the Stevens, Charavay and Vaughan cases, the purchase and sales by the respondents' firm *were of securities in which it specialized.* This dis-

tinction is specifically admitted by the Government in petitioner's brief (p. 7).

> "The transactions of the Schafer Brothers firm, however, involved purchases of securities other than those in which it specialized. These securities were held by it for resale at a profit upon an anticipated or hoped for rise of the market. Such purchases and sales, we believe, were mere speculations and did not serve to classify that firm as a merchant. On the other hand, in the instant case, the purchases and sales of the respondents' firm were of securities in which it specialized."

As was said in the Stevens case:

> "The dealings of the respondent's firm may not be said to be speculative only. The firm held at all times large blocks of stock which it sold in small lots to its various customers numbering at least one hundred, at different times, and it sold at different prices. It bought additional blocks of stock with which to replenish its supply. At all times it had shares of the stock to be sold for profit or loss, as the case may be, on resale. This was its wares or stock in trade * * * The record discloses that the firm bought in these taxable years the stocks of fourteen different corporations, as referred to, for its own account, as distinguished from its purchaser's account, all their purchases were intended for resale at a profit."

This is the exact situation in the instant case, and the Circuit Court so found.

> "We can find no material difference whatever between that case (Commissioner v. Stevens) and this. Following our decision in the Stevens Case, we feel bound to hold that the petitioners have shown themselves to be within the scope of the above-quoted regulation and entitled to the use they made of inventories" (R. 30, 31).

In *Harriman* v. *Commissioner,* 43 Fed. (2d) 950, the Court held that the Harriman National Bank was a dealer

as to the securities bought and sold for its own account for which it maintained a separate department.

The Government in that case attempted to draw inference, as in the instant case, from the testimony and the exhibits, that the real purpose of the bank in purchasing securities was for investment and not for resale. The Court below, however, refused to accept this contention and held the Bank to be a dealer in securities.

On the other hand in all the cases we have been able to find where the taxpayer was denied classification as a dealer the facts indicated that the taxpayer was not a specialist and was engaged in trading on his own account and not as part of a general business in securities.

Another case wherein the dealer classification was denied was *Seeley* v. *Commissioner,* 77 Fed. (2nd) 323.

Seeley had no established place of business, he had no customers, he never bought securities as a stock in trade to be sold thereafter to customers; he was merely a floor trader for a firm of which he was not even a member, and when he bought securities he did not buy for himself, he bought for the firm's customers, and when he sold he did not sell to those customers, but for them.

**Albert Fried & Company were entitled to inventory their securities since they regularly inventoried unsold securities on hand at market, and in its income tax returns for 1929, 1930 as well as 1931, computed its net income at market prices.**

This question is treated in great detail in the brief submitted by petitioner in the case of *Schafer* v. *Helvering,* Nos. 24, 25 and 26 (pp. 25-29) and respondents do not desire to burden the court with a repetition of the same arguments.

We accordingly submit that the record establishes that Albert Fried & Company has met the burden of proving that it had

(1) An established place of business.

(2) It was regularly engaged in the purchase of securities and their resale to customers.

(3) It was in fact a merchant of securities and like any merchant bought such securities and sold them to customers with a view to the gains and profits that may be derived therefrom.

and the Commissioner's action in denying them the use of inventories was not only erroneous but plainly arbitrary.

The Commissioner's action in this case is purely arbitrary in view of the decision in the *Hall* case where the Commissioner's refusal to classify a specialist as a dealer was reversed by the Board of Tax Appeals and the action of the Board of Tax Appeals was upheld by the Circuit Court of Appeals in *Commissioner* v. *Stevens*. The Circuit Court of Appeals further in the instant case held that there was no material difference between this case and the *Stevens* case.

## CONCLUSION

**It is respectfully submitted that the firm of Albert Fried & Company was a dealer in securities within the purview of the statutes and regulations and entitled to the use of inventories and that the decision of the Circuit Court of Appeals for the Second Circuit is correct and should be affirmed.**

Respectfully submitted,

JOHN J. CURTIN,
Counsel for Respondents.

# SUPREME COURT OF THE UNITED STATES.

Nos. 186 and 187.—October Term, 1936.

| | |
|---|---|
| Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, vs. Albert Fried. (186) | On Writs of Certiorari to the United States Circuit Court of Appeals for the Second Circuit. |
| Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, vs. Benjamin Einhorn. (187) | |

[December 7, 1936.]

Mr. Justice McReynolds delivered the opinion of the Court.

Respondents in these two causes were partners as Albert Fried & Company, brokers, member of the New York Stock Exchange, with offices at 120 Broadway. When he undertook to determine their individual taxable profits during 1931 the Commissioner denied their claim that the firm's operations on the Exchange as a "Specialist" in thirteen stocks gave it the status of dealer therein, entitled to the privilege of inventorying such securities for tax purposes at market value under Article 105, Treasury Regulations 74, Revenue Act 1928.

Upon stipulated facts the Board of Tax Appeals, although sharply divided, sustained his action. The Court below held the firm was a dealer within the Regulations, regarded *Commissioner* v. *Stevens*, 78 F. (2d) 713 as controlling, and reversed the Board's decision. Certiorari was granted here upon the Commissioner's petition, which affirms that the question presented is "Whether the respondents were dealers in certain securities in which they specialized so as to entitle them to inventory the securities at market value in determining income."

Pertinent provisions of the Revenue Act and Treasury Regulations are set out in the opinion in *Algernon S. Schafer, et al.* v. *Commissioner*, this day announced.

The stipulated facts show—

Alfred Fried and Benjamin Einhorn composed the firm, Alfred Fried & Company, 120 Broadway, organized in 1929, and member of New York Stock Exchange. It is a "Specialist" in thirteen specified stocks there bought and sold. A "Specialist" is a qualified member who accepts orders in selected securities from other members for execution.

As such "Specialist" the firm filled orders either by buying or selling its own securities or by matching like orders of buyer and seller. It leased space on the Exchange floor at an annual rental of $2,000.00, and there carried on business in the thirteen stocks. The firm was known to all members as a "Specialist" and was regularly and consistently engaged in purchases and resales. It is the practice for a member who desires to buy or sell a stock to place his order with the "Specialist" therein. The firm always had on hand the securities in which it specialized. The number (from 10,300 to 62,300) of shares of these owned by the firm at the end of each month in the year under review is stated. In one month—an example—of the 126,200 shares Air Reduction stock sold on the Exchange, 59% was sold by Fried & Company.

All stocks bought and sold by the firm were actually received and delivered. During the tax year it sold 1,762,100 shares of the thirteen stocks. Of other stocks it sold 119,600 shares.

Since its inception the firm has regularly inventoried unsold securities at the market and computed tax liability on that basis. On numerous occasions it purchased and sold in order to maintain fair and equitable markets and, as far as possible, has tried to prevent wide fluctuation in prices. During the year the partnership sold to 431 customers in amounts ranging from 100 to 5,700 shares. These customers were other members of the Stock Exchange acting for themselves or their principals.

We think the facts stipulated adequately establish that Fried & Company had an established place of business; that it regularly engaged in the purchase of certain specified securities and their resale to customers; that as a merchant it bought securities and sold them to customers with a view to the gains and profits that might be derived therefrom. Also that the evidence afforded no adequate basis for a contrary finding by the Board of Tax Appeals.

The Board's conclusion was announced (1934) prior to the decision (1935) of *Commissioner* v. *Stevens, supra.* In that cause, also in *Vaughan* v. *Commissioner,* 85 F. (2d) 497, the Circuit Court of Appeals, Second Circuit, describes the activities of "Specialists" on the Stock Exchange and concludes that they are dealers or merchants, in respect of the securities wherein they specialize, entitled to the benefit of Article 105 of Treasury Regulations 74.

We accept the conclusions reached below and need not repeat the adequate arguments advanced to support them.

*Affirmed.*

A true copy.

Test:

*Clerk, Supreme Court, U. S.*

Supreme Court of the United States

October Term, 1938

No. 168

BRONX COUNTY TRUST COMPANY, as ...
Fordham National Bank in New York,

v.

against

A. BRUCE BIELASKI and KEYES WINTER, ...
Trustees in Bankruptcy of Benedict Metal ...

PETITION FOR WRIT OF CERTIORARI ...
UNITED STATES CIRCUIT COURT OF ...
FOR THE SECOND CIRCUIT, AND ...
IN SUPPORT THEREOF

# INDEX.


| | PAGE |
|---|---|
| PETITION | 1 |
| Summary Statement of the Matter Involved | 1 |
| Reasons Relied on for Granting the Relief | 3 |
| BRIEF | 5 |
| Opinion Below | 5 |
| Jurisdiction | 5 |
| Statutes Involved | 5 |
| Statement of Case | 6 |
| Specification of Errors | 9 |
| ARGUMENT | 10 |
| POINT I—The alleged preferential payments worked no depletion in the assets of the Benedict Metal Works which would otherwise have been available to its general creditors | 10 |
| POINT II—There is no proof of any intent of the Benedict Metal Works to prefer the defendant or that the defendant bank had any cause to believe a preference was effected by the payments in question | 12 |
| POINT III—Plaintiffs wholly failed to prove insolvency of the Benedict Metal Works or that its insolvency was imminent at the time of the alleged preferential payments | 16 |

## TABLE OF CASES.


PAGE

Bielaski v. National City Bank, 58 Fed. (2d) 657, aff'd 68 Fed. (2d) 723 ..... 12, 13

Cardozo v. Brooklyn Trust Co., 228 Fed. 333 ..... 14

Credit Alliance Corp. v. Sheridan Theatre Co., 241 N. Y. 216 ..... 11

Cunningham v. Brown, 265 U. S. 1 ..... 11

Dalziel v. Rosenfeld, 265 N. Y. 76 ..... 12

Everett v. Warfield Mining Co., 37 Fed. (2d) 328 ..... 15

Grandison v. Robertson, 220 Fed. 985 ..... 15

Grant v. The First National Bank, 97 U. S. 80 ..... 15

Hoberg v. Sofransey, 248 N. Y. 141 ..... 11

McNaboe v. Columbian Mfg. Co., 153 Fed. 967 ..... 14

National Bank of Newport v. National Herkimer County Bank, 225 U. S. 178 ..... 11

New York County National Bank v. Massey, 192 U. S. 138, 147 ..... 11

Western Tie & Lumber Co. v. Brown, 196 U. S. 502, 509 ..... 11


## STATUTES.


Bankruptcy Act, Sec. 60(b) ..... 5, 9, 12

Judicial Code, Sec. 240(a) [U. S. C., Title 28, Sec. 347(a)] ..... 5

Stock Corporation Law of the State of New York, Sec. 15 ..... 5, 9

# Supreme Court of the United States

OCTOBER TERM, 1936

No. .....

BRONX COUNTY TRUST COMPANY, as successor to Fordham National Bank in New York,

Petitioner,

against

A. BRUCE BIELASKI and KEYES WINTER, as surviving Trustees in Bankruptcy of Benedict Metal Works, Inc.,

Appellees.

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

*To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:*

The petition of BRONX COUNTY TRUST COMPANY, by its counsel, Bertram Boardman, respectfully shows:

### Summary Statement of the Matter Involved.

The questions presented in this case are:

1. Whether the criminal activities of the treasurer of a corporation may be imputed to the corporation itself not only in the absence of evidence that the other officers and

directors authorized, or had knowledge of such activities, but in the face of uncontradicted testimony that neither such officers or directors, nor any of the employees of the corporation, had any knowledge of the same whatsoever.

2. Whether thefts and forgeries committed by the treasurer of the corporation for his own purposes were sufficient evidence of its insolvency and of an intent by such corporation (the bankrupt) to prefer the defendant bank.

3. Whether under the undisputed and uncontradicted evidence in the case there was any depletion of the bankrupt's estate.

4. Whether the plaintiff trustees in bankruptcy, ostensibly acting for all of the creditors of the bankrupt, may, in this action, recover moneys stolen by the treasurer of the bankrupt corporation from the Nassau National Bank, which moneys were traced directly into the defendant bank. The moneys having been obtained from the Nassau National Bank by means of forgeries committed by the bankrupt's treasurer for his own purposes, the transactions by which such moneys were obtained could have been set aside at the instance of the Nassau National Bank and such moneys reclaimed. For reasons unknown, this procedure was not adopted, but, instead, the plaintiff trustees, appointed at the instance of the Nassau National Bank, seek recovery in this action. The moneys in question never having become the property of the bankrupt corporation, but having been merely passed through the bank accounts of the said corporation, as the undisputed evidence clearly shows, such moneys never became part of the bankrupt's estate and there consequently was no depletion of such estate by the payments in question.

## Reasons Relied on for Granting Petition.

For reasons more fully set forth below, your petitioner submits that:

1. The learned District Judge and the Circuit Court of Appeals erred as a matter of law in deciding upon uncontradicted evidence that a preference had been committed under the Stock Corporation Law of the State of New York and under the Bankruptcy Act.

2. The decision below is contrary to any decision of the Supreme Court of the United States or of any other court which we have been able to find, or to which reference has been made by the plaintiffs.

3. The finding that the preference is in violation of the Bankruptcy Act is not only contrary to law but, if the decision below is sustained, it would add greatly to the perils of banking, in that every transaction by a bank with a corporate customer would be subject to the hazard of being set aside at some later date on a mere showing that one of the officers of such corporation (later become bankrupt) had been guilty of thefts and forgeries for his own purposes.

4. The result reached below is so far at variance with the law as established by the decisions of the Supreme Court of the United States that it should not be permitted to stand.

WHEREFORE, it is respectfully submitted that the petition for writ of certiorari should be granted.

BERTRAM BOARDMAN,
Attorney for Petitioner.

## BRIEF IN SUPPORT OF PETITION.

### Opinion Below.

The opinion of the District Judge is not reported. It appears in the record at pages 408 to 422. The Circuit Court of Appeals affirmed, without opinion.

### Jurisdiction.

This Court has jurisdiction to review the judgments below under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 [U. S. C., Title 28, Sec. 347(a)]. The date of the judgment sought to be reversed is June 4, 1936.

### Statutes Involved.

Section 60(b) of the Bankruptcy Act provides, in part, as follows:

> "If a bankrupt shall * * * have made a transfer of any of his property, and if, at the time of the transfer * * * and being within four months before the filing of the petition in bankruptcy or after the filing thereof and before the adjudication, the bankrupt be insolvent and the * * * transfer then operate as a preference, and the person receiving it * * * shall then have reasonable cause to believe that the * * * transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value from such person."

Section 15 of the Stock Corporation Law of the State of New York (Consolidated Laws, Chap. 59, Laws of 1923), as it existed in 1928 (same has been since amended), reads, in part, as follows:

> "PROHIBITED TRANSFERS TO OFFICERS OR STOCKHOLDERS. No corporation which shall have refused

to pay any of its notes or other obligations, when due, in lawful money of the United States, nor any of its officers or directors, shall transfer any of its property to any of its officers, directors or stockholders, directly or indirectly, for the payment of any debt, or upon any other consideration than the full value of the property paid in cash. No conveyance, assignment or transfer of any property of any such corporation by it or by any officer, director or stockholder thereof, nor any payment made, judgment suffered, lien created or security given by it or by any officer, director or stockholder when the corporation is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over other creditors of the corporation, shall be valid, * * *."

## Statement of Case.

(Page references are to the Transcript of Record.)

This action was brought to recover from the defendant, Fordham National Bank (since merged into the Bronx County Trust Company), the amount of three loans which had been made by the bank ostensibly to the Benedict Metal Works, Inc., the bankrupt corporation. The loans were made in January and March of 1928 and were repaid over a period extending from May 11, 1928, to June 20, 1928.

One John J. Sparler was the treasurer and a director and stockholder of the Benedict Metal Works; Bernard Benedict, the founder and organizer of the business, was its president and also a stockholder and director (pp. 68, 359).

At the time of the making of the loans aforesaid, the said Sparler had been and was, engaged in the commission of a series of forgeries and thefts whereby he obtained moneys from several of the large banks in the City of New York, by means of the forgery of trade acceptances and other negotiable paper and by the endorsement on such paper of the name of the Benedict Metal Works, Inc. This method he followed in obtaining from the Fordham Bank some $27,500, the amount in suit (p. 152).

It is not contended by the plaintiffs that the bank had any knowledge whatsoever of the spurious character of the paper discounted by it, nor was it contended on the trial that any other officer of the Benedict Metal Works knew at that time or at any other time until after the bankruptcy that Sparler had been engaged in these criminal activities, and indeed the record shows that the accountant and bookkeeper of the corporation were likewise in complete ignorance of the situation (pp. 61, 139, 185, 242).

Sparler was able to carry on this deception of his associates in business and of the employees of the bankrupt corporation by means of what was known as the "John J. Sparler Special Account" which was carried on the books of the corporation and wherein were credited and debited the moneys which Sparler obtained by means of his forgeries and thefts and those which he paid out from time to time to make good prior thefts and, it may be assumed, to avoid detection (p. 56; Plffs.' Ex. 12, p. 382; see also, pp. 69, 70, 135, 192).

It should be noted in passing that in addition to the forged paper represented by the three items in suit, the bank also loaned to the Benedict Metal Works on its own direct paper, that is, upon paper executed by itself as maker, payable to the bank the sum of $32,500. This direct paper was renewed and extended from time to time (and in the very period during which the alleged preferential payments were being made), and as a matter of fact at the time of the adjudication in bankruptcy, there remained due and unpaid to the defendant bank the sum representing the discount of this paper (pp. 98, 99; Plffs.' Ex. 1, p. 376).

The three payments which are the subject of this action were made by Sparler to the defendant bank with funds which he stole from the Nassau National Bank by means of the use of forged commercial paper. The proceeds of these forgeries were passed through the account of the Benedict Metal Works in the Nassau National Bank and immediately transferred and paid over to the Fordham National Bank. The transactions were characterized as "wash transactions" (p. 248); the moneys thus obtained by Sparler "went in and went out" of the Benedict account (pp. 306, 307).

Sparler stole from the Nassau National Bank in order to pay the Fordham National Bank or, in other words, as the learned counsel for the plaintiffs aptly stated, at the trial, Sparler "robbed Peter to pay Paul" (p. 252).

It thus appears that there was no depletion of any assets of the bankrupt corporation which rightfully belonged to its creditors.

Prior to the payments to the bank, Sparler and one Friedman had paid off obligations of the corporation totalling $215,000, for which an increase of stock of the corporation was voted thereby reducing its liabilities to creditors to that extent (pp. 75, 76, 77, 80). (This increase of capital stock sufficiently appears by Plffs.' Ex. 7, p. 380; Plffs.' Ex. 12, p. 382; Plffs.' Ex. 19, p. 385; Deft's Ex. F, pp. 402 *et seq.*).

In the meantime the business of the Benedict Metal Works was continuing right along; production increased, additions were made to its plant and machinery, salary and payroll were stepped up and all of the other factors indicated a continuance in business and demonstrated that insolvency and liquidation were never contemplated at the times of the alleged preferential payments (pp. 64-66, 67, 128, 129, 193, 194, 215, 216, 244, 285, 326).

The undisputed evidence shows that none of the officials of the defendant bank ever pressed Sparler for payment of the three items in question (p. 240), and as a matter of fact Sparler took his own good time in making the payments; the first request being at the end of April or early in May, the first payment being on May 11th and the last on June 20th of 1928 (pp. 214, 240).

Initial inquiry with respect to the paper discounted at the defendant bank was not engendered by anything that had occurred; but arose because of the establishment by the bank at that time of a system of checking which was then being installed (p. 146). Sparler himself was a director of the bank and so continued until some weeks after the transactions in question (pp. 34, 35). He was also the owner of record of 100 shares of stock of the bank and had given to the bank financial statements both of his company and him-

self showing considerable assets over liabilities (Deft.'s Exs. C and D, p. 400; Deft.'s Ex. E, p. 401). He gave a plausible explanation of the matter which was believed by the bank's officials, as is amply evidenced by the record (pp. 152, 154-155) as well as by their course of conduct then and at subsequent times.

There is here no dispute in the evidence. A pure question of law is involved. Do the facts constitute a voidable preference under the Bankruptcy Act and the New York Stock Corporation Law?

## Specification of Errors.

The District Court erred as a matter of law in holding:

1. That voidable preferential payments have been established under Section 60 (b) of the Bankruptcy Act and under Section 15 of the Stock Corporation Law of the State of New York;

2. That the alleged preferential payments depleted the assets of the bankrupt which would otherwise have been available to its general creditors;

3. That by the undisputed evidence the defendant had knowledge or reasonable cause to believe that a preference was intended;

4. That there was an intent by the bankrupt corporation to prefer the defendant;

5. That the Benedict Metal Works was insolvent or that its insolvency was imminent at the time of the alleged preferential payments;

6. That the defendant bank was a creditor of the corporation with respect to the payments in question;

7. The Circuit Court of Appeals erred in affirming the judgment of the District Court.

# ARGUMENT.

## POINT I.

**The alleged preferential payments worked no depletion in the assets of the Benedict Metal Works which would otherwise have been available to its general creditors.**

The undisputed testimony shows that the proceeds of Sparler's transactions were never carried on the books of the Benedict Metal Works as a liability of the bankrupt to the bank, all of these transactions being entered in the so-called "John J. Sparler Special Account." Neither the bookkeeper nor the accountant for the company ever knew of any liability by reason thereof.

The undisputed evidence is to the effect that by means of forgeries Sparler obtained moneys at one bank for the purpose of repaying to some other bank moneys which he had similarly obtained by means of forged paper and of forged endorsements of the name of Benedict Metal Works.

The evidence further shows, not only by the testimony of Sparler himself, but by an employee of the Nassau National Bank called by the plaintiffs, and by the exhibits in evidence, that Sparler "switched" the moneys that he obtained from the Nassau National Bank into the Fordham National Bank (pp. 256-259; Plffs.' Ex. 2, p. 377; Deft's. Exs. A and B, pp. 399-400; see also the stipulation on the record, p. 107).

The evidence is uncontradicted that the moneys so obtained, which were used in connection with the alleged preferential payments, never became the property of the Benedict Metal Works, never formed any part of the assets of that company, and, hence, the estate of the bankrupt was never depleted thereby.

The petitioner contends that as to these moneys, which were directly traced from the Nassau National Bank to the Fordham National Bank, the bank account of the Benedict Metal Works was used as a mere conduit by Sparler for his own uses and purposes.

There is no question but that had this money been found in the possession of the bankrupt or of the plaintiff-trustees, the Nassau National Bank could have set aside the transaction for fraud and reclaimed the same as its property (*Cunningham* v. *Brown,* 265 U. S. 1).

The petitioner contends that while the Nassau National Bank may have some cause of action in its favor by reason of the transactions in question, nevertheless these moneys cannot be recovered in this action at the suit of the trustees for the creditors.

It is well settled that unless an insolvent debtor so disposes of his property for the benefit of a creditor that the estate of the debtor which would otherwise be available to meet the claims of all creditors is diminished, a creditor cannot be charged with receiving a preference (*Western Tie & Lumber Co.* v. *Brown,* 196 U. S. 502, 509; *National Bank of Newport* v. *National Herkimer County Bank,* 225 U. S. 178; *New York County National Bank* v. *Massey,* 192 U. S. 138, 147).

In *Credit Alliance Corp.* v. *Sheridan Theatre Co.,* 241 N. Y. 216, the defendant's president, by means of forged paper, obtained a loan ostensibly to the defendant corporation, and deposited the proceeds of this loan in its bank account. Thereafter he withdrew the same by check. The Court of Appeals held that under the circumstances his acts were wholly unauthorized, he was not the defendant's agent and his knowledge could not be imputed to it.

In the case of *Hoberg* v. *Sofranscy,* 248 N. Y. 141, it appeared that a dishonest treasurer of what was an honest corporation (for all that the record showed), without its knowledge, utilized its name "in order to promote his personal rascalities." He did this by means of endorsements of the corporate name and his signature as treasurer. There, as here, there was nothing to indicate that he was authorized to endorse for the purposes which he did. The Court there held that the corporation was not answerable for the acts of its treasurer.

The defendant at bar sought to show that Sparler was not authorized to engage in his nefarious transactions. The evidence was excluded by the learned Trial Court (pp. 185, 186).

## POINT II.

**There is no proof of any intent of the Benedict Metal Works to prefer the defendant or that the defendant bank had any cause to believe a preference was effected by the payments in question.**

Under the provisions of Section 15 of the Stock Corporation Law of the State of New York, as the same existed in 1928, it was not necessary that the payee or transferee of moneys by a corporation have knowledge of an intent to prefer if the corporation was insolvent or its insolvency imminent (*Dalziel* v. *Rosenfeld*, 265 N. Y. 76). This harsh rule was modified by the Legislature in 1929, but even under the old rule plaintiffs failed to prove any cause of action under that section of the law or under Section 60(b) of the Bankruptcy Act.

If, as the record shows, none of the officers, directors or stockholders of the Benedict other than Sparler were aware of the latter's criminal activities, or knew of the payments in question until long after they were made, it is inconceivable how there could have been a preference by the corporation by the payments in question.

As a matter of fact, each payment was "an extraordinary payment dictated by the personal necessities of Sparler more than by any other consideration" (per Patterson, *D. J.*, in *Bielaski* v. *National City Bank*, 58 Fed. (2d) 657).

The decision in that case was affirmed by the Circuit Court of Appeals, 68 Fed. (2d) 723, but attention should be directed to the fact that the question of insolvency, as well as intent to prefer, was not there placed in issue as it was in the case at bar, Chase, *C. J.*, saying:

> "That the bankrupt (Benedict Metal Works) was insolvent when the notes were paid and intended to prefer the defendant over other creditors was not disputed."

Much stress was laid by the plaintiffs in the Circuit Court of Appeals below upon the decision in the foregoing case, but it should be borne in mind that the issues there were far different than those which were litigated at bar, particularly since the payments here at issue were made at different times and after the Benedict had been reorganized by the capitalization of $215,000 of its obligations into stock.

In *Bielaski* v. *National City Bank, supra,* it was assumed both by the litigants and by the learned Judges as well, that Sparler's acts were imputable to the Benedict Metal Works and that when he made the payment to that bank his purpose and intent, as well as his knowledge, were those of the corporation.

Here we have consistently contended to the contrary, but the learned Trial Judge below ignored the contention and speaks in his opinion as though Sparler's criminal activities were those of the corporation's, when there is not the slightest evidence to sustain any such thesis.

Furthermore, in that case the action of the bank clearly indicated guilty knowledge—or so it could have been found. Thus the discovery by the bank of Sparler's wrongdoing was followed by peremptory demands for immediate payment. That payment was accompanied by the burning of the forged paper which Sparler had given and both he and the Benedict were rushed out of the bank and the account closed.

In the case at bar, all these, or similar, circumstances are lacking. Here there never was knowledge by the bank or any cause whatever to believe that Sparler was a thief until long after the bankruptcy, when his criminalities were exposed for the first time. Here there was no peremptory demand for payment, but merely a request that the paper be taken out of the bank. The payments were spread over a period of six weeks, at Sparler's own convenience and in his own good time and without further discussion.

The opinion of the District Judge below also states that the payments made by Sparler were made to enable him "to keep a step ahead of detection" (p. 410).

Also important is that there is not the slightest evidence that the Benedict was winding up its affairs or contemplating liquidation or bankruptcy at the time. These were necessary elements which the plaintiffs failed to prove (*Cardozo* v. *Brooklyn Trust Co.*, 228 Fed. 333).

In *McNaboe* v. *Columbian Mfg. Co.*, 153 Fed. 967 (the Circuit Court of Appeals affirming on the opinion of Hough, *D. J.*), the president of the bankrupt took moneys and passed the same through the bankrupt's bank account and therewith made restitution of moneys that he had stolen from another, "by such repayment probably saving himself from criminal prosecution," but the transaction, including payment and repayment, being something of which the defendant had no knowledge and "as to which the law expressly repudiates any imputation to the corporation of a dishonest director's knowledge," recovery was denied.

Then there is the renewal by the bank of the direct paper of the Benedict to the extent of $32,500 and the fact that this sum remained unpaid at the time of the bankruptcy. If the bank were anxious for payment, or knew or had reasonable cause to believe that the Benedict was insolvent or that its insolvency was imminent, it is inconceivable that some effort would not have been made to obtain payment of this larger sum.

The undisputed evidence is that no pressure was put upon Sparler and that the bank had no knowledge of Sparler's activities, and he continued as one of its directors long after the making of the alleged payments.

The payments in question extended over a period of nearly two months from the time that the bank first requested Sparler to liquidate the obligations in question. Thus there was no evidence of either haste or anxiety on the part of the bank.

All of the facts negative any knowledge or intent on the part of the bank and the finding of the Trial Court of such knowledge or intent is erroneous and without any evidence whatsoever to support it.

In *Grant* v. *The First National Bank*, 97 U. S. 80, Justice Bradley held that even though the officers of a bank had reason to be suspicious, that fact fell short of establishing that they had reasonable cause to believe that their customer was insolvent.

In *Everett* v. *Warfield Mining Co.*, 37 Fed. (2d) 328, it was said that a creditor may feel anxious about his claim and have a strong desire to secure it or have it paid, and yet such circumstances do not bring the transaction within the prohibition of the statute.

In *Grandison* v. *Robertson*, 220 Fed. 985, it was said:

> "The bankruptcy act does not take away from a banker the right to transact business with his customer in the ordinary way. He may take renewal notes in extension of credit and receive partial payment of his debt, and has the right during the continuance of their relations to presume that his debtor is solvent and carrying on business in the usual way; and if it turns out that the debtor was insolvent the creditor may receive payment without incurring the liability of having to restore such payment when bankruptcy intervenes."

None of the familiar badges of fraud or of guilty knowledge are present in the case at bar. The record discloses the ordinary situation existing between bank and customer. Only after the bankruptcy were Sparler's activities discovered. Knowledge gained at that time cannot be used to establish a situation which existed prior thereto.

If this case is to stand, it establishes a precedent which will make it hazardous for a bank to deal with a corporation, for transactions entered into in good faith may be set aside upon a mere showing that an officer of the customer was a thief. Such is not, and should not be, the law.

## POINT III.

**Plaintiffs wholly failed to prove insolvency of the Benedict Metal Works or that its insolvency was imminent at the time of the alleged preferential payments.**

The learned Court erred in admitting in evidence financial statements purporting to show the condition of the bankrupt on March 31st, June 30th and August 24th, 1928 (Plffs.' Exs. 26, 27, 28, pp. 392-396). Both the accountants who prepared these exhibits and the Trial Judge disregarded the capital increase of $215,000, although the books of the bankrupt corporation clearly reflected this transaction.

The learned Trial Court refused to permit testimony as to the agreement between Sparler and one Friedman relating to this stock increase (pp. 205-207). It is submitted that this ruling is error and related to a material matter. The plaintiffs' accountant conceded that by this refinancing the Benedict had a surplus of assets over liabilities of $106,000 (pp. 323, 327, 333).

In view of the record and exhibits, which undisputably show that the authorized capital of the corporation had been increased by appropriate resolution of the stockholders, the filing of the requisite certificate of increase with the Secretary of State and the payment of the tax and filing fees thereon, it must be held as a matter of law that a valid stock increase had been consummated and the learned Trial Judge fell into error in holding to the contrary.

**The plaintiffs did not sustain the burden which was cast upon them of proving a single one of the elements necessary in order to establish the cause of action alleged in the complaint.**

Dated, July 7, 1936.

Respectfully submitted,

BERTRAM BOARDMAN,
Attorney for Petitioner.

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CHARLES ELMORE

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1936.

No. 188.

BRONX COUNTY TRUST COMPANY, as successor to Fordham National Bank in New York,

*Petitioner,*

AGAINST

A. BRUCE BIELASKI and KEYES WINTER, as surviving Trustees in Bankruptcy of Benedict Metal Works Inc.,

*Appellees.*

## Brief of Trustees in Bankruptcy in Opposition to Petition for Writ of Certiorari.

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# INDEX.


| | PAGE |
|---|---|
| Brief of Trustees in Bankruptcy in Opposition to Petition for Writ of Certiorari | 1 |
| POINT I.—The bankrupt's estate was depleted by the payments made to the petitioner | 4 |
| POINT II.—The bankrupt intended to prefer the petitioner | 8 |
| POINT III.—Under Section 15 of the Stock Corporation Law of the State of New York as it existed when the payments were made to the petitioner, its belief that a preference would be effected was of no moment | 9 |
| POINT IV.—The petitioner knew or had reasonable cause to believe it was being preferred | 10 |
| POINT V.—The finding of insolvency or imminent insolvency of the bankrupt was warranted by the proof | 11 |
| CONCLUSION.—The petitioner has failed to present any substantial legal question for review by this Court and, accordingly, certiorari should be denied | 12 |

## CASES CITED.


| | PAGE |
|---|---|
| Bielaski *v.* National City Bank, 58 F. (2d) 657, affirmed 67 F. (2d) 723 | 3, 8 |
| Conrow *v.* Little, 115 N. Y. 387 | 5 |
| Cunningham *v.* Brown, 265 U. S. 1 | 6 |
| Credit Alliance Corp. *v.* Sheridan Theatre, 241 N. Y. 216 | 7 |
| Hoberg *v.* Sofransey, 248 N. Y. 141 | 7 |
| Matters *v.* Manufacturers Trust Co., 54 F. (2d) 1010, 1014 | 8 |
| Pender *v.* Chatham, 58 F. (2d) 968, 970 | 10 |


## STATUTES CITED.


| | |
|---|---|
| New York Negotiable Instruments Law, §§115, 116 | 5 |
| United States Code, Title XI, Chapter 6, Section 96 (b) | 2 |

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A. BRUCE BIELASKI and KEYES WINTER, as surviving Trustees in Bankruptcy of Benedict Metal Works, Inc.,

*Appellees.*

---

## Brief of Trustees in Bankruptcy in Opposition to Petition for Writ of Certiorari.

By this application for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit, the petitioner seeks to have this Court accept for review an order of the said Circuit Court affirming, without opinion, the judgment of the United States District Court for the Southern District of New York in favor of the trustees and against the petitioner in the sum of $38,906.62. The opinion of the District Court (Rippey, *D. J.*) is reported (14 F. Supp. 971).

The action was by the trustees to recover, as unlawful preferences, three payments made by BENEDICT METAL WORKS, INC., the bankrupt, to the petitioner.

Both Section 15 of the Stock Corporation Law of the State of New York and Section 60-b of the Acts of Congress relating to bankruptcy (United States Code, Title XI, Chapter 6, Section 96 [b]) were alleged to have been violated.

On this application, the petitioner contends, as it did in the court below, that the order of the Circuit Court of Appeals and the judgment of the District Court are erroneous for three legal reasons, viz., (1) that the payments to the petitioner did not deplete the estate of the bankrupt; (2) that the record does not contain any proof of intent of the bankrupt to prefer the petitioner or that the petitioner knew or had reasonable cause to believe it was being preferred by the payments made to it by the bankrupt (Section 60 of the Bankruptcy Act); (3) that the record does not contain any proof of the insolvency or imminent insolvency of the bankrupt at the time of the payments.

Apart from the question of insolvency or its imminence, the points made by the petitioner arise from the following facts, as to which there was no substantial dispute:

One Sparler was the bankrupt's vice-president, treasurer and general manager. The bankrupt, a corporation, had conferred upon Sparler full and complete authority to sign and endorse commercial paper and to discount the same at various banks, including the petitioner. Regardless of his official title, the bankrupt, its business and finances were completely dominated and controlled by Sparler. To keep the bankrupt in business, Sparler secured bank credits by endorsing for discount and discounting a large number of spurious receivables (promissory notes and trade acceptances) for the bankrupt's account at various banks, including the petitioner. In addition, he borrowed large sums of money upon the discount of the bankrupt's own paper, beguiling the banks with false financial statements. By these methods, Sparler established for the

bankrupt a substantial revolving fund, in that moneys raised at one or more banks were used to take up maturing items at the same or other banks. The proceeds of all discounts went into the accounts of the bankrupt. Detection of Sparler's forgeries or his utterance of forged papers was avoided for a long time by meticulous prepayment of those papers. He never permitted a paper to be presented to the purported maker or acceptor. The bankrupt's (and Sparler's) troubles began, however, when, in the spring of 1928, Sparler gave The National City Bank of New York six notes, each in the sum of $11,650.00, bearing the name of one Ball as maker, as collateral security for some borrowing which Sparler had arranged upon the bankrupt's own notes. Ball, although a resident of Indiana, was known to the officers of that bank as a man of great affluence. That Ball should have outstanding notes of long maturity aroused suspicion and prompted investigation. Ball promptly repudiated the notes and the bankrupt, through Sparler, was compelled forthwith to clean up its indebtedness to The National City Bank of New York. Part of the payment made to that bank has been recovered by the trustees (*Bielaski* v. *National City Bank*, 58 F. [2d] 657, affirmed 67 F. [2] 723).

Later, other banks, including petitioner, learned of Sparler's crimes and applied pressure to get their notes and receivables paid. In desperation, Sparler sought still other banks which he could similarly dupe. He succeeded in prevailing upon The Nassau National Bank of Brooklyn to give the bankrupt a liberal line of credit on its own papers as well as on receivables. Through the discount of the bankrupt's own papers and of forged receivables with the latter bank, the bankrupt raised the money necessary to take up three admittedly forged receivables held by the Fordham National Bank in New York (now the petitioner). Each of the payments made by the bankrupt to the petitioner emanated from the bankrupt's account with The Nassau National Bank of Brooklyn.

From the record, it is impossible to ascertain whether the payments to the petitioner were made from moneys raised upon the bankrupt's own papers or upon forged receivables. The first of the three payments was made on May 11, 1928, by check of the bankrupt in the sum of $4,132.30 drawn on its account with The Nassau National Bank of Brooklyn. The second was accomplished by a debit charge of $11,650.00 on May 23, 1928, against the account of the bankrupt with the petitioner. This debit charge and payment were made possible by a transfer of funds of the bankrupt from The Nassau National Bank of Brooklyn to the petitioner. A check of the bankrupt on the former was deposited in the bankrupt's account with the petitioner on May 17, 1928. Without this deposit, the charge and payment could not have been made. The third payment was made on June 21, 1928, by the bankrupt's check of $11,650.00 drawn on the petitioner. Another transfer of funds from the bankrupt's account with The Nassau National Bank of Brooklyn made this payment possible. This transfer was made by check of the bankrupt to its order drawn upon The Nassau National Bank of Brooklyn and deposited in its account with the petitioner on June 20, 1928. The record shows that from May 9, 1928, The Nassau National Bank of Brooklyn discounted forged receivables for the bankrupt's account, and in addition the bankrupt's account was also credited with the proceeds of discounts of its own paper.

## POINT I.

**The bankrupt's estate was depleted by the payments made to the petitioner.**

The above point is the converse of the first argument made in petitioner's behalf on this application. Essentially, the contention is made that because Sparler defrauded The Nassau National Bank of Brooklyn in

obtaining the funds with which the petitioner was paid, the funds, although raised on the authorized signature of the bankrupt, were not the property of the bankrupt immediately prior to such payment. To whom the money belonged is not stated, but the suggestion is made that The Nassau National Bank of Brooklyn "could have set aside the transaction for fraud and reclaimed the same as its property" if found in the possession of the bankrupt or the trustees.

In making this contention, the petitioner ignores the fundamental principle of contract law that fraud does not *ipso facto* avoid a contract. It is merely voidable at the option of the defrauded party (*Conrow* v. *Little*, 115 N. Y. 387). In Sparler's dealings with The Nassau National Bank of Brooklyn, he was clothed with the authority to sign and endorse paper for discount for the bankrupt's account. The bankrupt became liable to the bank on all paper which it discounted for the account of the bankrupt on the signature of Sparler as its authorized agent. Each discount, whether of the bankrupt's paper or a receivable, involved a contract between the bankrupt and the bank, and regardless of any fraud (forgery or false financial statement) the contract existed. Each such contract imported an obligation to pay the bank a sum of money and, in the case of the discount of receivables, the endorsement of the bankrupt bound it to the warranties and engagements imposed by law upon a general endorser (New York Negotiable Instruments Law, §§115 and 116). In each instance of discount the bank credited the bankrupt's account with the proceeds. The bankrupt became the owner of the credit.

True, the bank, because of the fraud perpetrated upon it, might have rescinded the discount contracts and cancelled the credit, or, if the money had been transferred and could be traced, the bank might "have asserted possession of it on the ground that there was a resulting trust in their (its) favor, or they (it) could have

established a lien for what was due them (it) in any fund of which he (the bankrupt) had made it a part'' (*Cunningham* v. *Brown,* 265 U. S. 1).

The Nassau National Bank of Brooklyn did not rescind the discount contracts. It filed a general claim in the bankruptcy proceeding on the discount contracts. Accordingly, any question of title to the funds in the bankrupt's account representing the proceeds of discounts is completely obviated. Such funds were clearly the property of the bankrupt available to meet the claims of its creditors. The transfer of such funds to pay indebtednesses owing to the petitioner constituted a depletion of the bankrupt's estate.

The remainder of petitioner's argument of non-depletion overlooks the power and authority conferred by the bankrupt upon Sparler to sign and endorse commercial paper in its name. That Sparler had such general power and authority is admitted. When he exercised such power and authority in the discount of notes and acceptances, the bankrupt's account (not Sparler's) was credited with the proceeds. The moneys were invariably used for corporate purposes (fol. 558). Sparler's forgeries were personal crimes in the sense that they were not authorized or consciously sanctioned by the bankrupt. But the corporation benefited thereby and because it had conferred upon Sparler the authority to borrow money in its name, the fact that Sparler violated the criminal law in order to accomplish such purpose does not relieve the bankrupt of liability on the discounted paper or deprive it of ownership of the proceeds of the discounts. The ownership of such bank credits is a necessary corollary to the bankrupt's liability on the discounted paper.

The position of the petitioner with respect to its claim of $32,500.00 against the bankrupt is inconsistent with its claim of non-depletion. In addition to the three papers, the payment of which has been adjudged preferential, the petitioner holds the bankrupt's discounted

note of $32,500.00 signed by Sparler for which it has filed a general claim. This loan was induced by a false financial statement of the bankrupt which Sparler furnished to the petitioner. The books of the bankrupt did not disclose the liability on this paper (fol. 802, petitioner's brief, p. 7). It was, however, entered in the "John J. Sparler Special Account".

If the petitioner's argument is sound, that by such paper the bankrupt incurred no liability and the disbursement of the proceeds of the discount thereof did not result in depletion, how can it maintain that it has a claim against the bankrupt's estate on the note of $32,500?

On the question of the liability of a corporation for the acts of an officer, the petitioner cites two cases of recent origin, namely, *Credit Alliance Corp.* v. *Sheridan Theatre*, 241 N. Y. 216, and *Hoberg* v. *Sofranscy*, 248 N. Y. 141. Neither case involved a preference. The decision in both turned on the question of authority to sign or endorse notes. In both cases the plaintiff failed because authority was lacking. Those cases are distinguishable from that at bar in that here Sparler's authority was unquestioned.

Stated simply, the instant case was decided, not on the answer to the question whether Sparler was acting for the bankrupt in forging papers or issuing false financial statements, but upon the issue whether he had the authority to bind the bankrupt on a note or endorsement. The latter authority he concededly had. It was proper, therefore, to exclude testimony offered by the petitioner that Sparler was never expressly empowered to commit crimes in the corporation's behalf (fols. 555, 556).

All of the borrowings by Sparler in the bankrupt's name went into the bankrupt's accounts. Such funds, regardless of the devices or methods by which they were obtained, were available to its general creditors unless and until reclaimed by the defrauded lenders.

Payment to the petitioner out of such funds depleted the assets of the bankrupt and, if the other elements of a preference have been proved, the petitioner obtained a greater share of the bankrupt's assets available to its creditors than others.

In urging the point of non-depletion, the petitioner ignores its pleading (answer to the amended complaint, Transcript of Record, pp. 12-15). The trustees alleged in their amended complaint (Paragraphs Eighth and Sixteenth, fols. 17, 22) as amended on the trial (fols. 54, 56) that the payments were made by the bankrupt. These allegations were not put in issue. Accordingly, depletion is admitted and no issue on that proposition existed. The District Judge so held (fol. 1260).

## POINT II.

### The bankrupt intended to prefer the petitioner.

Admittedly, Sparler committed many crimes over a long period to keep the bankrupt from financial collapse. There is no denying that for all practical purposes, he was the bankrupt's *alter ego*. Of course, he knew of its insolvency. "A concern that is solvent does not raise money by means of forged paper" (PATTERSON, *D. J.* in *Bielaski* v. *National City Bank*, 58 F. [2d] 657, 660). The practice of "robbing Peter to pay Paul" must have been done with the consciousness that when the crimes were discovered "Peter" would be sacrificed because "Paul" had been paid. Such consciousness is tantamount to the prohibited intent. That intent is admirably expressed by Judge Learned Hand in *Matters* v. *Manufacturers Trust Co.*, 54 F. (2d) 1010, 1014, where he said:

> "It is still a preference if a debtor, knowing that he is insolvent, selects one creditor, though he believes he will not go to the wall, if the dice

> fall right. He must actually believe that the gods will smile; it is not enough that their faces are inscrutable.''

It is inconceivable that Sparler, acting for the bankrupt, could have had a real belief that the bankrupt would succeed to the point where it would continue in business and pay its creditors in full. This is particularly so since Sparler's crimes had already been detected by several of the banks duped by him and his financial operations seriously curtailed. The end was drawing near.

The petitioner maintains that the business of the bankrupt was being continued with no idea of liquidation or winding up and argues therefrom that the unlawful intent could not have existed. The record shows that the bankrupt's business was being operated at a substantial loss for a long time and in April, 1928, the directors of the bankrupt acknowledged that it was in financial difficulties (Plaintiffs' Exhibit 19, fol. 1156). Even assuming that, regardless of insolvency, a voluntary liquidation was not in contemplation, it is evident that enforced cessation and winding up of the business was ever imminent because of the frauds which Sparler, in the bankrupt's behalf, had perpetrated.

It is difficult to imagine a case where the finding of an intent to prefer would be more justified.

## POINT III.

**Under Section 15 of the Stock Corporation Law of the State of New York as it existed when the payments were made to the petitioner, its belief that a preference would be effected was of no moment.**

The petitioner is in accord with the point. If, therefore, as found by the trial court, the payments were made when the bankrupt was insolvent or imminently

so and it intended a preference thereby, the trustees' cause has been sufficiently established to entitle them to a recovery under the state statute, regardless of the consciousness of the petitioner at the time of the payments. Accordingly, even if the trustees have failed by their proof to sustain a bankruptcy preference (the courts below allowed a recovery under the bankruptcy statute as well as the state law) there is still no basis for disturbing the judgment.

## POINT IV.

### The petitioner knew or had reasonable cause to believe it was being preferred.

It is undoubtedly the law that notice of facts which would incite a man of ordinary prudence to an inquiry is sufficient to charge a creditor with knowledge of facts which a reasonably diligent inquiry would have disclosed (*Pender* v. *Chatham,* 58 F. [2d] 968, 970). Section 60 of the Bankruptcy Act does not require that the creditor have actual knowledge, either of insolvency or that a preference would be effected, but the test is: do the facts within the knowledge (actual or constructive) of the creditor justify the inference or belief that a preference was being given?

The District Judge held that because the petitioner had "discovered" on and after April 28, 1928, the spurious character of the paper Sparler had been discounting for the bankrupt's account, it was put upon inquiry and was chargeable with knowledge of the insolvency of the bankrupt and of the resulting preference which the payments effected. The testimony of the petitioner's president (Miller, fols. 86-93) and its credit manager (Stearns, fols. 435-473) left no opportunity of escape from the conclusion that the petitioner was put upon inquiry. Such inquiry would necessarily have disclosed the bankrupt's insolvency and that the peti-

tioner was being preferred. When evidence of forgery by a debtor is at hand, it is idle to argue, as petitioner does, that "suspicion" is insufficient upon which to predicate reasonable cause to believe the debtor to be insolvent. This is especially so when it is considered that after learning of Sparler's irregularities, the petitioner "persuaded" the bankrupt to anticipate the maturity of the forged papers.

A more convincing case of "reasonable cause to believe" is difficult to conceive.

## POINT V.

**The finding of insolvency or imminent insolvency of the bankrupt was warranted by the proof.**

The record presented a fair question of fact on the issue of the bankrupt's insolvency. In view of the large amounts involved in the forgeries, the imminence of insolvency is hardly debatable. The finding that $215,000 of its liabilities were not converted into capital was clearly justified by the proof that the certificate of increase was not filed until June 20, 1928 (the day upon which the last payment was made to the petitioner) and that nothing was done thereafter to accomplish the increase. All that appears in the record is that an option to purchase the stock upon the increase was given to Friedman, who, with Sparler, became a creditor of the bankrupt when they furnished the equities to take up the bankrupt's obligation to the Bronx Borough Bank and Cosmopolitan Bank.

Insolvency was unquestionably shown. At best, the petitioner may assert that the proof presented a question of fact on that issue. That question has been resolved against the petitioner and, of course, this Court will not substitute its judgment of the facts for that of the courts below.

No legal question is presented in the petitioner's point of lack of proof of insolvency.

## CONCLUSION.

***The petitioner has failed to present any substantial legal question for review by this Court and, accordingly, certiorari should be denied.***

Respectfully submitted,

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